

TUCOWS INC /PA/
Form 10-Q
November 12, 2010
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2010

OR

o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from to

Commission file number 1-32600

TUCOWS INC.

Edgar Filing: TUCOWS INC /PA/ - Form 10-Q

(Exact Name of Registrant as Specified in Its Charter)

Pennsylvania
(State or Other Jurisdiction of
Incorporation or Organization)

23-2707366
(I.R.S. Employer
Identification No.)

96 Mowat Avenue,

Toronto, Ontario M6K 3M1, Canada

(Address of Principal Executive Offices) (Zip Code)

(416) 535-0123

(Registrant's Telephone Number, Including Area Code)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days: Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T §232.405 of this chapter during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of large accelerated filer, accelerated filer, and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer

Accelerated filer

Non-accelerated filer
(Do not check if a smaller reporting company)

Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act): Yes No

As of November 12, 2010, there were 53,448,491 outstanding shares of common stock, no par value, of the registrant.

Table of Contents

TUCOWS INC.

Form 10-Q Quarterly Report

INDEX

PART I
FINANCIAL INFORMATION

<u>Item 1.</u>	<u>Consolidated Financial Statements</u>	3
	<u>Consolidated Balance Sheets as of September 30, 2010 (unaudited) and December 31, 2009</u>	3
	<u>Consolidated Statements of Operations (unaudited) for the three and nine months ended September 30, 2010 and 2009</u>	4
	<u>Consolidated Statements of Cash Flows (unaudited) for the three and nine months ended September 30, 2010 and 2009</u>	5
	<u>Notes to Consolidated Financial Statements (unaudited)</u>	6
<u>Item 2.</u>	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	17
<u>Item 3.</u>	<u>Quantitative and Qualitative Disclosures About Market Risk</u>	33
<u>Item 4.</u>	<u>Controls and Procedures</u>	34

PART II
OTHER INFORMATION

<u>Item 1.</u>	<u>Legal Proceedings</u>	34
<u>Item 1A.</u>	<u>Risk Factors</u>	34
<u>Item 6.</u>	<u>Exhibits</u>	35
<u>Signatures</u>		36

TRADEMARKS, TRADE NAMES AND SERVICE MARKS

Tucows®, Butterscotch® and OpenSRS® are registered trademarks of Tucows, Inc. or its subsidiaries. Other service marks, trademarks and trade names of Tucows, Inc. or its subsidiaries may be used in this Quarterly Report on Form 10-Q (this Quarterly Report). All other service marks, trademarks and trade names referred to in this Quarterly Report are the property of their respective owners. Solely for convenience, any trademarks referred to in this Quarterly Report may appear without the ® or TM symbol, but such references are not intended to indicate, in any way, that we or the owner of such trademark, as applicable, will not assert, to the fullest extent under applicable law, our or its rights, or the right of the applicable licensor, to these trademarks.

Table of Contents**PART I.****FINANCIAL INFORMATION****Item 1. Consolidated Financial Statements****Tucows Inc.****Consolidated Balance Sheets****(Dollar amounts in U.S. dollars)**

	September 30, 2010 (unaudited)	December 31, 2009
Assets		
Current assets:		
Cash and cash equivalents	\$ 5,431,589	\$ 9,632,394
Accounts receivable, net of allowance for doubtful accounts of \$110,000 as of September 30, 2010 and December 31, 2009	3,332,277	2,822,045
Prepaid expenses and deposits	2,437,566	2,498,922
Derivative instrument asset, current portion (note 6)	576,581	2,107,825
Prepaid domain name registry and ancillary services fees, current portion	36,621,716	31,596,236
Income taxes recoverable	547,000	674,000
Total current assets	48,946,729	49,331,422
Derivative instrument asset, long-term portion (note 6)	5,436	112,553
Prepaid domain name registry and ancillary services fees, long-term portion	12,887,593	12,126,515
Property and equipment	1,410,195	1,986,768
Deferred financing charges	20,900	41,000
Deferred tax asset, long-term portion (note 7)	3,870,038	3,907,476
Intangible assets (note 4)	17,333,237	18,656,353
Goodwill	17,990,807	17,990,807
Total assets	\$ 102,464,935	\$ 104,152,894
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable	\$ 1,156,803	\$ 1,547,863
Accrued liabilities	1,625,663	1,889,980
Customer deposits	3,702,464	3,624,317
Derivative instrument liability, current portion (note 6)	37,933	
Loan payable, current portion (note 5)	1,784,443	3,220,125
Deferred revenue, current portion	45,475,807	40,211,766
Accreditation fees payable, current portion	545,694	530,656
Deferred tax liability, current portion (note 7)	870,038	907,476
Total current liabilities	55,198,845	51,932,183

Edgar Filing: TUCOWS INC /PA/ - Form 10-Q

Derivative instrument liability, long-term portion (note 6)	8,445	15,708
Deferred revenue, long-term portion	16,858,661	16,098,812
Accreditation fees payable, long-term portion	168,464	169,620
Deferred tax liability, long-term portion (note 7)	4,840,000	4,840,000
Stockholders' equity (note 11)		
Preferred stock - no par value, 1,250,000 shares authorized; none issued and outstanding		
Common stock - no par value, 250,000,000 shares authorized; 57,362,236 shares issued and outstanding as of September 30, 2010 and 67,080,353 shares issued and outstanding as of December 31, 2009		
	12,107,580	14,030,384
Additional paid-in capital	42,623,860	47,287,351
Deficit	(29,340,920)	(30,221,164)
Total stockholders' equity	25,390,520	31,096,571
Total liabilities and stockholders' equity	\$ 102,464,935	\$ 104,152,894

See accompanying notes to unaudited consolidated financial statements

Table of Contents**Tucows Inc.****Consolidated Statements of Operations****(Dollar amounts in U.S. dollars)**

	Three months ended September 30,		Nine months ended September 30,	
	2010	2009	2010	2009
	(unaudited)		(unaudited)	
Net revenues (note 9)	\$ 21,209,468	\$ 20,496,129	\$ 62,501,219	\$ 60,609,673
Cost of revenues:				
Cost of revenues (*)	15,991,455	14,770,868	46,372,315	42,942,314
Depreciation of property and equipment	231,253	347,619	794,368	1,316,986
Amortization of intangible assets (note 4)	74,802	29,199	224,406	87,597
Total cost of revenues (note 9)	16,297,510	15,147,686	47,391,089	44,346,897
Gross profit	4,911,958	5,348,443	15,110,130	16,262,776
Operating expenses:				
Sales and marketing (*)	1,830,999	1,568,727	5,480,228	4,261,070
Technical operations and development (*)	1,053,768	1,142,331	3,486,718	3,421,825
General and administrative (*)	633,457	1,145,951	2,049,813	4,608,173
Depreciation of property and equipment	40,239	47,249	127,559	221,937
Loss on disposition of property and equipment		40,369		40,369
Amortization of intangible assets (note 4)	360,540	360,540	1,081,620	1,081,620
(Gain) loss on change in fair value of forward exchange contracts	(141,981)	(1,878,230)	1,669,031	(3,902,394)
Total expenses	3,777,022	2,426,937	13,894,969	9,732,600
Income from operations	1,134,936	2,921,506	1,215,161	6,530,176
Other (expenses) income :				
Interest (expense) income, net	(26,917)	(52,887)	(99,812)	(178,669)
Other income		1,880,000		4,493,190
Total other (expenses) income	(26,917)	1,827,113	(99,812)	4,314,521
Income before provision for income taxes	1,108,019	4,748,619	1,115,349	10,844,697
(Recovery of) provision for income taxes (note 7)	24,863	(447,455)	235,105	241,621
Net income for the period	\$ 1,083,156	\$ 5,196,074	\$ 880,244	\$ 10,603,076
Basic earnings per common share (note 8)	\$ 0.02	\$ 0.08	\$ 0.01	\$ 0.15
Shares used in computing basic earnings per common share (note 8)	57,351,161	68,008,871	59,255,739	69,841,981
Diluted earnings per common share (note 8)	\$ 0.02	\$ 0.08	\$ 0.01	\$ 0.15
Shares used in computing diluted earnings per common share (note 8)	59,185,793	68,874,517	61,223,369	70,156,521

(*) Stock-based compensation has been included in expenses as follows:

Cost of revenues	\$	6,557	\$	3,860	\$	15,759	\$	12,227
Sales and marketing		30,358		12,807		71,589		42,764
Technical operations and development		19,058		12,395		51,903		34,116
General and administrative		99,813		70,748		174,437		142,641

See accompanying notes to unaudited consolidated financial statements

Table of Contents**Tucows Inc.****Consolidated Statements of Cash Flows****(Dollar amounts in U.S. dollars)**

	Three months ended September 30,		Nine months ended September 30,	
	2010	2009	2010	2009
	(unaudited)		(unaudited)	
Cash provided by (used in):				
Operating activities:				
Net income for the period	\$ 1,083,156	\$ 5,196,074	\$ 880,244	\$ 10,603,076
Items not involving cash:				
Depreciation of property and equipment	271,492	394,868	921,927	1,538,923
Loss on disposition of property and equipment		40,369		40,369
Amortization of deferred financing charges	6,000	9,100	20,100	29,200
Amortization of intangible assets	435,342	389,739	1,306,026	1,169,217
Gain on disposal of investment in Afiliis		(1,880,000)		(3,890,395)
Reduction in deferred tax liability		(497,000)		(497,000)
Disposal of domain names	5,084	649	17,090	2,596
Unrealized (gain) loss in the fair value of forward exchange contracts	(141,981)	(1,878,230)	1,669,031	(3,902,394)
Stock-based compensation	155,786	99,810	313,688	231,748
Changes in non-cash operating working capital:				
Accounts receivable	53,373	(465,454)	(510,232)	(729,520)
Prepaid expenses and deposits	489,843	419,761	61,356	(469,462)
Prepaid fees for domain name registry and ancillary services fees	(2,355,886)	33,425	(5,786,558)	(2,588,476)
Income tax recoverable	(165,000)	(835,398)	127,000	
Accounts payable	(244,194)	(977,967)	(443,624)	(597,560)
Accrued liabilities	(231,633)	(115,362)	(264,317)	(111,719)
Customer deposits	240,907	592,612	78,147	445,079
Deferred revenue	2,287,739	(398,657)	6,023,890	2,314,334
Accreditation fees payable	(14,435)	(46,762)	13,882	(2,457)
Net cash provided by operating activities	1,875,593	81,577	4,427,650	3,585,559
Financing activities:				
Proceeds received on exercise of stock options			14,809	25,422
Repurchase of common stock		(570,335)	(6,914,792)	(2,381,514)
Repayment of loan payable	(478,561)	(478,561)	(1,435,682)	(2,160,682)
Net cash used in financing activities	(478,561)	(1,048,896)	(8,335,665)	(4,516,774)
Investing activities:				
Cost of domain names acquired				(5,900)
Additions to property and equipment	(33,111)	(281,282)	(292,790)	(426,292)
Proceeds on disposal of investment in Afiliis		1,980,000		4,090,395
Net cash (used in) provided by investing activities	(33,111)	1,698,718	(292,790)	3,658,203
Increase (decrease) in cash and cash equivalents	1,363,921	731,399	(4,200,805)	2,726,988

Edgar Filing: TUCOWS INC /PA/ - Form 10-Q

Cash and cash equivalents, beginning of period		4,067,668		7,423,056		9,632,394		5,427,467
Cash and cash equivalents, end of period	\$	5,431,589	\$	8,154,455	\$	5,431,589	\$	8,154,455
Supplemental cash flow information:								
Interest paid	\$	27,001	\$	52,983	\$	99,798	\$	181,012
Supplementary disclosure of non-cash investing activity:								
Property and equipment acquired during the period not yet paid for	\$	146,158	\$	343,777	\$	146,158	\$	343,777

See accompanying notes to unaudited consolidated financial statements

Table of Contents

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

1. ORGANIZATION OF THE COMPANY:

Tucows Inc., a Pennsylvania corporation (referred to throughout this report as the Company, Tucows, we, us or through similar expressions), together with our consolidated subsidiaries, is a global distributor of Internet services, including domain name registration, security and identity products through digital certificates and email through its distribution network of Internet Service Providers, web hosting companies and other providers of Internet services to end-users.

We were incorporated under the laws of the Commonwealth of Pennsylvania in November 1992 under the name Infonautics, Inc. In August 2001, we completed our acquisition of Tucows Inc., a Delaware corporation, and we changed our name from Infonautics, Inc. to Tucows Inc. Our principal executive office is located in Toronto, Ontario and we have other offices in the United Kingdom and the United States.

2. BASIS OF PRESENTATION:

The accompanying unaudited interim consolidated balance sheets, and the related consolidated statements of operations and cash flows reflect all adjustments, consisting of normal recurring adjustments, that are, in the opinion of management, necessary for a fair presentation of the financial position of Tucows and its subsidiaries as at September 30, 2010 and the results of operations and cash flows for the interim periods ended September 30, 2010 and 2009. The results of operations presented in this Quarterly Report on Form 10-Q are not necessarily indicative of the results of operations that may be expected for future periods.

The accompanying unaudited interim consolidated financial statements have been prepared by Tucows in accordance with the rules and regulations of the Securities and Exchange Commission (the SEC). Certain information and footnote disclosure normally included in the Company's annual audited consolidated financial statements and accompanying notes have been condensed or omitted. These interim consolidated financial statements and accompanying notes follow the same accounting policies and methods of application used in the annual financial statements and should be read in conjunction with the Company's audited consolidated financial statements and notes thereto for the year ended December 31, 2009 included in Tucows' 2009 Annual Report on Form 10-K filed with the SEC on March 22, 2010.

There have been no material changes to our significant accounting policies during the nine months ended September 30, 2010 as compared to the significant accounting policies described in our Annual Report on Form 10-K for the fiscal year ended December 31, 2009.

During fiscal 2010, the Company recorded out-of-period adjustments relating to rent expense and the amortization of intangible assets. These immaterial corrections of errors reduced net income after taxes by \$35,000 for the three months ended September 30, 2010 and by \$0.1 million for the nine months ended September 30, 2010.

The Company recognizes the effects of events or transactions that occur after the balance sheet date but before financial statements are issued (subsequent events) if there is evidence that conditions related to the subsequent event existed at the date of the balance sheet date, including the impact of such events on management's estimates and assumptions used in preparing the financial statements. Other significant subsequent events that are not recognized in the financial statements, if any, are disclosed to the notes to the unaudited interim consolidated financial statements.

3. NEW ACCOUNTING POLICIES:

Recent Accounting Pronouncements Adopted

No new accounting pronouncements have been adopted during the three and nine months ended September 30, 2010.

Recent Accounting Pronouncement Not Yet Adopted

In October 2009, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update 2009-13, Revenue Recognition (Topic 605): Multiple-Deliverable Revenue Arrangements (Update 2009-13). Update 2009-13 applies to multiple-deliverable revenue arrangements that are currently within the scope of FASB ASC Subtopic 605-25 (previously included in Emerging Issues Task Force Issue no. 00-21, Revenue Arrangements with Multiple Deliverables). Update 2009-13 provides principles and application guidance on whether multiple deliverables exist, how the arrangement should be separated, and the consideration allocated. It also requires an entity to allocate revenue in an arrangement using estimated selling prices of deliverables if a vendor does not have vendor-specific objective evidence or third-party evidence of selling price. The guidance eliminates the use of

Table of Contents

the residual method, requires entities to allocate revenue using the relative-selling-price method, and significantly expands the disclosure requirements for multiple-deliverable revenue arrangements. Update 2009-13 is effective on a prospective basis for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. We are currently assessing the impact of Update 2009-13 on our future consolidated financial statements.

Regulatory Update

In October 2009, the SEC issued Press Release 2009-213, *Small Public Companies to Begin Providing Audited Assessment of Internal Controls over Financial Reporting in Nine Months* (Press Release 2009-213). Press Release 2009-213 requires public companies with a public float below \$75 million begin to comply with Section 404(b) of the Sarbanes-Oxley Act of 2002 for annual reports with fiscal years ending on or after June 15, 2010. Section 404(b) requires that companies report on the effectiveness of their internal control over financial reporting.

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the *Financial Reform Act*). Section 989G of the Financial Reform Act exempts companies with a public float below \$75 million from compliance with Section 404(b) of the Sarbanes-Oxley Act of 2002. Accordingly, Tucows will only be required to provide auditor attestation of the effectiveness of its internal control over financial reporting for fiscal years in which its public float exceeds \$75 million on June 30th of such fiscal year.

4. INTANGIBLE ASSETS:

Intangible assets consist of acquired technology, brand, customer relationships, surname domain names and our portfolio of domain names. As reflected in the table below, these balances are being amortized on a straight-line basis over the life of the intangible assets, except for the surname domain names and portfolio domain names; which have been determined to have an indefinite life and which are tested annually for impairment.

A summary of acquired intangible assets for the three months ended September 30, 2010 is as follows:

Amortization period	Technology 2 - 7 years	Brand 7 years	Customer relationships 4 - 7 years	Surname domain names indefinite life	Direct navigation domain names indefinite life	Total
Net book value, June 30, 2010	\$ 175,324	\$ 603,300	\$ 2,770,820	\$ 12,130,461	\$ 2,093,758	\$ 17,773,663
Sale of domain names				(2,596)	(2,488)	(5,084)
Amortization expense	(74,802)	(41,760)	(318,780)			(435,342)
Net book value, September 30, 2010	\$ 100,522	\$ 561,540	\$ 2,452,040	\$ 12,127,865	\$ 2,091,270	\$ 17,333,237

A summary of acquired intangible assets for the nine months ended September 30, 2010 is as follows:

Edgar Filing: TUCOWS INC /PA/ - Form 10-Q

Amortization period	Technology 2 - 7 years	Brand 7 years	Customer relationships 4 - 7 years	Surname domain names indefinite life	Direct navigation domain names indefinite life	Total
Net book value, December 31, 2009	\$ 324,928	\$ 686,820	\$ 3,408,380	\$ 12,132,408	\$ 2,103,817	\$ 18,656,353
Sale of domain names				(4,543)	(12,547)	(17,090)
Amortization expense	(224,406)	(125,280)	(956,340)			(1,306,026)
Net book value, September 30, 2010	\$ 100,522	\$ 561,540	\$ 2,452,040	\$ 12,127,865	\$ 2,091,270	\$ 17,333,237

5. LOAN PAYABLE:

The Company entered into a non-revolving, reducing credit facility (the credit facility) in the amount of \$9.6 million with the Bank of Montreal (the Bank) to finance the purchase of Innerwise, Inc. in July 2007. On September 10, 2010, the Company amended the credit facility (as amended, the Amended Credit Facility), the terms of which are more fully described in the Company s Current Report on Form 8-K, filed with the SEC on September 13, 2010.

Table of Contents

The Company's Amended Credit Facility continues to provide for repayment of the \$ 1,784,443 outstanding balance under the existing non-revolving, reducing demand loan with the Bank (the Existing Demand Loan). In addition, the Bank has made available an additional \$2,000,000 non-revolving, reducing demand loan to the Company (the Additional Demand Loan) to finance the repurchase of shares of the Company's common stock., and the Amended Credit Facility continues to provide for the existing \$3,500,000 Treasury Risk Management Facility (the TR Loan), and together with the Existing Demand Loan, the Existing Loans). The Existing Loans are governed by the terms of the Loan Agreement, dated as of July 25, 2007 (as amended from time to time, the 2007 Loan Agreement) by and among the Company, Tucows.com Co., a wholly owned subsidiary of Tucows Inc. (Borrower), and certain subsidiaries of the Company named therein (the Guarantors), and the Financing Commitment, dated as of July 19, 2007, by and between Borrower and Bank (the Term Sheet and together with the 2007 Loan Agreement, the 2007 Loan Documents). The terms of the 2007 Loan Documents have been described more fully in the Company's Current Report on Form 8-K, filed with the Securities and Exchange Commission on July 31, 2007, and such description is incorporated herein by reference.

The Amended Credit Facility also provides for a new \$1,000,000 operating demand loan (the Operating Demand Loan Facility) to fund operational requirements pursuant to the terms of the Operating Loan Agreement with the Bank, which such terms are described in the Offer Letter, dated as of August 30, 2010, by and between the Company and the Bank (the Offer Letter and together with the Operating Loan Agreement, the 2010 Loan Documents).

Under the Amended Credit Facility, the \$1,738,443 outstanding balance on the Existing Demand Loan is to be repaid in equal monthly installments of \$159,520 plus interest. Any advances under the Additional Demand Loan are to be paid in equal monthly installments over 60 months. For both the Existing Demand Loan and the Additional Demand Loan the Company can elect to pay interest either at the Bank of Montreal (BMO) U.S. Base Rate plus 1.30% (amended from plus 1.50%) or at LIBOR plus 3.25%. All interest is payable monthly in arrears as incurred. The Additional Demand Loan is subject to an undrawn aggregate standby fee of 0.20% following the first draw which is payable quarterly in arrears. The Borrower will continue to make annual cash sweep payments to the Bank based on the Company's annual audited financial statements. The cash sweep payments will be applied to outstanding amounts under the Existing Demand Loan and Additional Demand Loan.

Under the 2010 Loan Documents, the Borrower has agreed to pay to the order of the Bank any outstanding principal amounts under the Operating Demand Loan Facility plus interest, at a rate of BMO U.S. Base Rate plus 1.30% Interest is payable monthly in arrears with any borrowing under the facility fluctuating widely with periodic clean-up, at a minimum on an annual basis. The Borrower has also agreed to pay to the Bank a monthly monitoring fee of \$500. The Operating Demand Loan Facility is payable on demand at any time, at the sole discretion of the Bank, with or without cause.

All obligations under the Amended Credit Facility are guaranteed by the Company pursuant to a Guaranty, dated July 25, 2007 (the Guaranty), executed by the Company in favor of the Bank, and are secured by a security interest in substantially all of the Company's assets granted under the Security Agreement (the Security Agreement), dated July 25, 2007, executed by the Company in favor of the Bank. Each other Guarantor has similarly guaranteed and secured the Borrowers' obligations and have entered into similar Guaranty and Security Agreements in favor of the Bank.

The Bank, at its sole option, with or without cause, may accelerate payment of any obligations under the 2010 Loan Documents and may terminate the Operating Demand Loan Facility at any time. The Bank may refuse to honor any check or permit any transfer or withdrawal upon (i) any default by the Borrower under any agreement between the Borrower and the Bank; (ii) the death of any Guarantor or termination of any guaranty of amounts owed under the Amended Credit Facility; (iii) the Operating Demand Loan Facility exceeding the \$1,000,000 limit; or (iv) any demand made for payment of the Operating Demand Loan Facility.

Pursuant to the 2010 Loan Documents, the Borrower has agreed to comply with certain customary non-financial covenants regarding maintenance of insurance; payment of taxes; disposition of major assets; compliance with statutes and with environmental standards; reporting requirements; timely provision of notices of default; absence of material judgments; access to books and records; prohibition on assumption of additional debt or guarantee obligations by the Borrower, subject to certain exceptions for capital expenditures; and prohibition on the payment of dividends.

The 2010 Loan Documents, the Existing Demand Loan and the Additional Demand Loan require that Borrower comply with the following financial covenants: (i) Maximum Senior Funded Debt to EBITDA of 2.00:1; (ii) Maximum Total Funded Debt to EBITDA of 2.50:1; and (iii) Minimum Fixed Charge Coverage of 1.25:1. Further, the Borrower's Maximum Annual Capital Expenditures cannot exceed \$3,600,000 per year, which such limit will be reviewed on an annual basis. As of September 30, 2010, the Company has continued to comply with all covenants under the Amended Credit Facility, and the interest rate at September 30, 2010 was 3.59%.

Table of Contents

Under the 2010 Loan Documents the Borrower is prohibited from, among other things: (i) amalgamating, merging or reorganizing with any corporation; (ii) entering into a transaction that effects a change in control of the Borrower and /or a loan guarantor, subject to certain stated exceptions; (iii) selling, assigning or otherwise disposing of any fixed asset, machinery, equipment or immovable property subject to the Bank's security interest; (iv) creating, assuming or permitting to exist any security interest or other encumbrances on any of its assets ranking prior to or pari passu with or after the assets secured under the Security Agreement, except for permitted encumbrances; and (v) incurring any new debt other than the Loan.

The foregoing summary of the Amended Credit Facility, 2010 Loan Agreement, Offer Letter, 2007 Loan Agreement, Guaranty and Security Agreement does not purport to be complete and is qualified in its entirety by reference to the full text of each of the Operating Loan Agreement, Offer Letter, 2007 Loan Agreement, Guaranty and Security Agreement, which are included as Exhibits 10.1, 10.2, 10.3, 10.4 and 10.5, respectively, to this Quarterly Report on Form 10-Q and are incorporated herein by reference.

To estimate the fair value of the Company's loans payable under the Amended Credit Facility, the Company uses interest rates that are currently available to the Company for issuance of loans on similar terms and remaining maturities. The estimated fair value of the Company's loan payable at September 30, 2010 was \$1,766,283, compared to a carrying amount of \$1,784,443 at September 30, 2010.

6. DERIVATIVE INSTRUMENT ASSETS AND LIABILITIES:

The Company enters into foreign currency contracts to hedge a portion of the Company's expected Canadian dollar requirements. All derivative financial instruments are recorded at fair value on our consolidated balance sheet. The fair value of our foreign currency contracts at September 30, 2010 was a net unrealized gain of \$0.5 million as compared to a net unrealized gain of \$2.2 million at December 31, 2009. The net unrealized gain is a result of fluctuations in foreign exchange rates between the date the currency forward contracts were entered into and the valuation date at period end.

At September 30, 2010, the Company had the following outstanding forward exchange contracts to trade U.S. dollars in exchange for Canadian dollars:

Maturity date	Notional amount of U.S. dollars	Weighted average exchange rate of U.S. dollars	Fair value
October - December 2010	5,400,000	0.9236	280,870
2010	5,400,000	0.9236	280,870
January - March 2011	5,400,000	0.9307	225,103
April - June 2011	3,900,000	0.9635	14,779
June - September 2011	3,900,000	0.9604	17,896
October - December 2011	1,950,000	0.9644	(3,009)
2011	15,150,000	0.9508	254,769
Total	\$ 20,550,000	0.9435	\$ 535,639

During the nine months ended September 30, 2010, the Company entered into a series of foreign exchange forward contracts to hedge a portion of our 2011 fiscal year expected Canadian dollar requirements. These contracts, collectively, have a notional value of US\$10.0 million, whereby amounts of US\$250,000, US\$400,000 or US\$650,000 are converted into Canadian dollars on a semi-monthly basis from January 2011 to November 2011 at an average foreign exchange rate of US\$1.00:Cdn\$1.0437.

The Company does not apply hedge accounting and, therefore, for the three months ended September 30, 2010, the Company recorded a gain of \$0.1 million in the fair value of forward contracts in its consolidated statements of operations. For the nine months ended September 30, 2010, the Company recorded a loss of \$1.7 million in the fair value of forward contracts in its consolidated statements of operations. For the three and nine months ended September 30, 2009, the Company recorded a gain on forward contracts of \$1.9 million and \$3.9 million respectively.

Table of Contents

7. INCOME TAXES

For the nine months ended September 30, 2010, the Company recorded a provision for income taxes of \$0.2 million on income before income taxes of \$1.1 million, using an estimated effective tax rate for its 2010 fiscal year adjusted for certain foreign exchange losses for which the Company does not anticipate obtaining a current tax benefit. Included in the provision for income taxes is a recovery of \$0.1 million in respect of refundable Ontario research tax credits. Comparatively, for the nine months ended September 30, 2009, the Company recorded a current tax expense of \$0.2 million on income before income taxes of 10.8 million, using an estimated effective tax rate for its 2009 fiscal year that accounts for the utilization of remaining net operating loss carry forwards and alternative minimum tax credits available to the Company.

As of December 31, 2009, the Company recorded a valuation allowance of \$4.3 million and a net deferred tax asset of \$3.0 million. As of September 30, 2010 the Company has recorded a non-current deferred tax asset of \$3.9 million and current deferred tax liabilities of \$0.9 million. As of September 30, 2010 and December 31, 2009, the Company has also recorded a non-current deferred tax liability related to the temporary difference arising on indefinite life intangibles of \$4.8 million.

The Company analyzes the carrying value of its deferred tax asset on a regular basis. In determining future taxable income, assumptions are made to forecast federal, state and international operating income, the reversal of temporary timing differences, and the implementation of any feasible and prudent tax planning strategies. The assumptions require significant judgment regarding the forecasts of future taxable income, and are consistent with other forecasts used to manage the business. During the nine months ended September 30, 2010, there was no reversal of the valuation allowance. The valuation allowance will be maintained until sufficient evidence exists to support a reversal of, or decrease in, the valuation allowance.

The Company follows the provisions of FASB ASC Topic 740, Income Taxes to account for income tax exposures. The application of this interpretation requires a two-step process that separates recognition of uncertain tax benefits from measurement thereof.

The Company had approximately \$0.1 million of total gross unrecognized tax benefit as of September 30, 2010 and \$0.1 million of total gross unrecognized tax benefit as of December 31, 2009, which if recognized would favorably affect our income tax rate in future periods. The unrecognized tax benefit relates primarily to prior year Pennsylvania state franchise taxes and other insignificant US state taxes. The unrecognized tax benefit has decreased by \$17,000 as of September 30, 2010 when compared to the gross unrecognized tax benefits as of December 31, 2009 as we have now settled the claim for the Pennsylvania franchise taxes for the years December 31, 1996 to December 31, 2000. The Company does not expect the unrecognized tax benefit for its 2010 research and development claim to be significant. The Company recognizes accrued interest and penalties related to taxes in tax expense. The Company did not have significant interest and penalties accrued as of September 30, 2010 and December 31, 2009, respectively. The Company believes it is reasonably possible that \$0.1 million of the unrecognized tax benefit will decrease in the next twelve months as it is anticipated that the U.S. tax authorities will finalize their review of prior taxes owing in Pennsylvania within the period and certain other prior year state tax returns will be filed.

Table of Contents**8. BASIC AND DILUTED EARNINGS PER COMMON SHARE:**

Basic earnings per common share has been calculated by dividing net income for the period by the weighted average number of common shares outstanding during each period. Diluted earnings per share has been calculated by dividing net income for the period by the weighted average number of common shares and potentially dilutive common shares outstanding during the period. In computing diluted earnings per share, the treasury stock method is used to determine the number of shares assumed to be purchased from the conversion of common shares equivalents or the proceeds of option exercises.

The following table is a summary of the basic and diluted earnings per common share:

	Three months ended September 30, 2010	Three months ended September 30, 2009	Nine months ended September 30, 2010	Nine months ended September 30, 2009
Numerator for basic and diluted earnings per common share:				
Net income for the period	\$ 1,083,156	\$ 5,196,074	\$ 880,244	\$ 10,603,076
Denominator for basic and diluted earnings per common share:				
Basic weighted average number of common shares outstanding	57,351,161	68,008,871	59,255,739	69,841,981
Effect of outstanding stock options	1,834,632	865,646	1,967,630	314,540
Diluted weighted average number of shares outstanding	59,185,793	68,874,517	61,223,369	70,156,521
Basic earnings per common share	\$ 0.02	\$ 0.08	\$ 0.01	\$ 0.15
Diluted earnings per common share	\$ 0.02	\$ 0.08	\$ 0.01	\$ 0.15

For the three months ended September 30, 2010, outstanding options to purchase 3,755,000 shares were not included in the computation of diluted income per common share because all such options had exercise prices greater than the average market price of the common shares. During the three months ended September 30, 2009, outstanding options to purchase 3,468,420 common shares were not included in the computation of diluted income per common share because all such options had exercise prices greater than the average market price of the common shares.

For the nine months ended September 30, 2010, outstanding options to purchase 3,023,500 common shares were not included in the computation of diluted income per common share because all such options had exercise prices greater than the average market price of the common shares. During the nine months ended September 30, 2009, outstanding options to purchase 4,015,587 common shares, were not included in the computation of diluted income per common share because all such options had exercise prices greater than the average market price of the common shares.

On January 13, 2010, 6,341,470 common shares were repurchased and cancelled under the terms of a modified Dutch auction tender offer.

Edgar Filing: TUCOWS INC /PA/ - Form 10-Q

During the nine months ended September 30, 2010, 3,409,300 common shares were repurchased and cancelled under the terms of our stock repurchase program announced in February 2010. No shares were repurchased under this program during the three months ended September 30, 2010.

The computation of earnings per share and diluted earnings per share for the three and nine months ended September 30, 2010 include reductions in the number of shares outstanding due to these purchases (see note 11).

9. SUPPLEMENTAL INFORMATION:

The following is a summary of the Company's revenue earned from each significant revenue stream:

	Three months ended September 30,		Nine months ended September 30,	
	2010	2009	2010	2009
OpenSRS :				
Domain Services	\$ 16,517,427	\$ 15,097,640	\$ 47,669,347	\$ 44,037,596
Email Services	577,606	842,262	1,796,452	2,838,052
Other Services	1,086,102	1,109,341	3,264,758	3,295,789
Total OpenSRS Services	18,181,135	17,049,243	52,730,557	50,171,437
YummyNames	1,249,128	1,781,725	4,592,297	5,102,315
Hover	1,147,576	1,203,742	3,388,036	3,763,155
Butterscotch	631,629	461,419	1,790,329	1,572,766
	\$ 21,209,468	\$ 20,496,129	\$ 62,501,219	\$ 60,609,673

Table of Contents

No customer accounted for more than 10% of the Company's revenue for the three and nine months ended September 30, 2010 or the three and nine months ended September 30, 2009. Significant management judgment is required at the time revenue is recorded to assess whether the collection of the resulting receivables is reasonably assured. On an ongoing basis, we assess the ability of our customers to make required payments. Based on this assessment, we expect the carrying amount of our outstanding receivables, net of allowance for doubtful accounts, to be fully collected.

As of September 30, 2010, two customers accounted for 29% of accounts receivable, all of which has been paid subsequent to September 30, 2010. As of September 30, 2009, no customer accounted for more than 10% of accounts receivable.

The following is a summary of the Company's cost of revenues from each significant revenue stream:

	Three months ended September 30,		Nine months ended September 30,	
	2010	2009	2010	2009
OpenSRS :				
Domain Services	\$ 13,817,541	\$ 12,325,620	\$ 39,523,115	\$ 35,624,222
Email Services	97,001	103,071	321,459	436,216
Other Services	416,938	411,949	1,204,403	1,212,087
Total OpenSRS Services	14,331,480	12,840,640	41,048,977	37,272,525
YummyNames	179,894	218,371	636,389	654,456
Hover	380,262	493,181	1,129,996	1,481,761
Butterscotch	11,889	25,491	56,127	33,341
Network, other costs	1,087,930	1,193,185	3,500,826	3,500,231
Network, depreciation and amortization costs	306,055	376,818	1,018,774	1,404,583
	\$ 16,297,510	\$ 15,147,686	\$ 47,391,089	\$ 44,346,897

The following is a summary of the Company's property and equipment by geographic region:

	September 30, 2010		December 31, 2009	
Canada	\$ 994,170	\$ 1,475,056		
United States	416,025	506,533		
United Kingdom		5,179		
	\$ 1,410,195	\$ 1,986,768		

10. COMMITMENTS AND CONTINGENCIES:

The Company is involved in various legal claims and lawsuits in connection with its ordinary business operations. The Company intends to vigorously defend these claims. While the final outcome with respect to any actions or claims outstanding or pending as of September 30, 2010 cannot be predicted with certainty, management believes that their resolution will not have a material adverse effect on the Company's financial position.

Table of Contents**11. STOCKHOLDERS EQUITY:**

The following unaudited table summarizes stockholders' equity transactions for the nine month period ended September 30, 2010:

	Shares	Common stock Amount	Additional paid in capital	Deficit	Total stockholders equity
Balances, December 31, 2009	67,080,353	\$ 14,030,384	\$ 47,287,351	\$ (30,221,164)	\$ 31,096,571
Exercise of stock options	33,678	27,350	(12,540)		14,810
Repurchase and retirement of shares Dutch Auction	(6,341,470)	(1,268,294)	(3,222,692)		(4,490,986)
Repurchase and retirement of shares Normal course issuer bid	(3,409,300)	(681,860)	(1,741,947)		(2,423,807)
Stock-based compensation			157,902		157,902
Cancellation of restricted stock	(650)				
Net loss for the period				(202,912)	(202,912)
Balances, June 30, 2010	57,362,611	12,107,580	42,468,074	(30,424,076)	24,151,578
Stock-based compensation			155,786		155,786
Cancellation of restricted stock	(450)				
Net income for the period				1,083,156	1,083,156
Balances, September 30, 2010	57,362,161	\$ 12,107,580	\$ 42,623,860	\$ (29,340,920)	\$ 25,390,520

The following unaudited table summarizes stockholders' equity transactions for the nine month period ended September 30, 2009.

	Number	Common stock Amount	Additional paid in capital	Deficit	Total stockholders equity
Balances, December 31, 2008	73,073,782	\$ 15,198,358	\$ 48,714,676	\$ (42,462,370)	\$ 21,450,664
Exercise of stock options	68,707	46,858	(21,436)		25,422
Repurchase and retirement of shares	(4,185,769)	(837,138)	(974,041)		(1,811,179)
Stock-based compensation			131,938		131,938
Issuance of restricted stock	12,600				
Cancellation of restricted stock	(100)				
Net income for the period				5,407,002	5,407,002
Balances, June 30, 2009	68,969,220	14,408,078	47,851,137	(37,055,368)	25,203,847
Stock-based compensation			99,810		99,810
Cancellation of restricted stock	(300)				
Repurchase and retirement of shares	(1,103,824)	(220,765)	(349,570)		(570,335)
Net income for the period				5,196,074	5,196,074
Balances, September 30, 2009	67,865,096	\$ 14,187,313	\$ 47,601,377	\$ (31,859,294)	\$ 29,929,396

Edgar Filing: TUCOWS INC /PA/ - Form 10-Q

On January 13, 2010, the Company announced that it successfully concluded a modified Dutch auction tender offer that was previously announced on December 14, 2009. Under the terms of the offer, the Company repurchased an aggregate of 6,341,470 shares of its common stock at a purchase price of \$0.70 per share, for a total of \$4,439,029, excluding transaction costs of \$51,957. The purchase price was funded from available cash. Of the 6,341,470 shares purchased, 5,000,000 were shares the Company offered to purchase in the offer and 1,341,470 were shares purchased pursuant to the Company's right to purchase up to an additional 2% of the shares outstanding immediately prior to the commencement of the tender offer. Due to over-subscription, the final proration factor for shares tendered at or below \$0.70 per share was approximately 99.9%. For this purpose, shares tendered at \$0.70 per share included shares tendered by those persons who indicated, in their letter of transmittal, that they were willing to accept the price determined in the offer. All shares purchased in the tender offer received the same price.

On February 16, 2010, the Company's Board of Directors authorized the repurchase of up to \$10 million of the Company's common stock at the Company's discretion. Under this repurchase program, the Company did not repurchase any shares during the three months ended September 30, 2010, and repurchased 3,409,300 shares during the nine months ended September 30, 2010. This

Table of Contents

repurchase program was terminated on September 9, 2010 when Tucows announced its intention to commence a Dutch Auction Tender Offer.

12. SHARE-BASED PAYMENTS

(a) Stock options

The Company's 1996 Stock Option Plan (the "1996 Plan") was established for the benefit of the employees, officers, directors and certain consultants of the Company. The maximum number of common shares which may be set aside for issuance under the 1996 Plan was 11,150,000 shares, provided that the Board of Directors of the Company has the right, from time to time, to increase such number subject to the approval of the stockholders of the Company when required by law or regulatory authority. Generally, options issued under the 1996 Plan vest over a four-year period. The 1996 Plan expired on February 25, 2006 and no options have been issued from the 1996 Plan after that date.

The Company's Amended and Restated 2006 Equity Compensation Plan (the "2006 Plan"), serves as a successor to the 1996 Plan. The 2006 Plan was established for the benefit of the employees, officers, directors and certain consultants of the Company. The Plan was amended and restated at the Annual General Meeting of the Stockholders on September 7, 2010 to extend the term thereof to September 6, 2020 and to increase the number of shares of common stock authorized for issuance thereunder from 5,000,000 to 6,900,000. The 6,900,000 common shares that have been set aside for issuance under the 2006 Plan are to provide eligible persons with the opportunity to acquire a proprietary interest, or otherwise increase their proprietary interest, in Tucows. Generally, options issued under the 2006 Plan vest over a four-year period and have a term not exceeding seven years.

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model, consistent with the guidance on stock compensation. Because option-pricing models require the use of subjective assumptions, changes in these assumptions can materially affect the fair value of the options. The assumptions presented in the table below represent the weighted average of the applicable assumption used to value stock options at their grant date. The Company calculates expected volatility based on historical volatility of the Company's common shares. The expected term, which represents the period of time that options granted are expected to be outstanding, is estimated based on historical exercise experience. The Company evaluated historical exercise behavior when determining the expected term assumptions. The risk-free rate assumed in valuing the options is based on the U.S. Treasury yield curve in effect at the time of grant for the expected term of the option. The Company determines the expected dividend yield percentage by dividing the expected annual dividend by the market price of our common shares at the date of grant.

During the three months ended September 30, 2010, stock options to purchase 220,000 common shares were granted, compared to 200,000 common shares granted during the three months ended September 30, 2009.

During the nine months ended September 30, 2010, stock options to purchase 1,794,000 common shares were granted, compared to 245,000 common shares granted during the three months ended September 30, 2009. During the nine months ended September 30, 2009, the only stock option grants made were formula grants to Independent Directors.

Edgar Filing: TUCOWS INC /PA/ - Form 10-Q

The stock options granted during the three and nine months ended September 30, 2010 expire on various dates through 2017.

Details of stock option transactions for the three months ended September 30, 2010 and September 30, 2009 are as follows:

	Three months ended September 30, 2010		Three months ended September 30, 2009	
	Number of shares	Weighted average exercise price per share	Number of shares	Weighted average exercise price per share
Outstanding, beginning of period	8,224,083	\$ 0.56	7,029,258	\$ 0.56
Granted	220,000	0.62	200,000	0.56
Exercised				
Forfeited	(61,042)	0.65	(35,656)	0.72
Expired				
Outstanding, end of period	8,383,041	\$ 0.56	7,193,602	\$ 0.56
Options exercisable, end of period	6,267,541	\$ 0.51	6,060,574	\$ 0.53

Edgar Filing: TUCOWS INC /PA/ - Form 10-Q

Table of Contents

Details of stock option transactions for the nine months ended September 30, 2010 and September 30, 2009 are as follows:

	Nine months ended September 30, 2010		Nine months ended September 30, 2009	
	Number of shares	Weighted average exercise price per share	Number of shares	Weighted average exercise price per share
Outstanding, beginning of period	7,203,977	\$ 0.56	7,282,777	\$ 0.56
Granted	1,794,000	0.69	225,000	0.54
Exercised	(33,678)	0.44	(68,707)	0.37
Forfeited	(99,167)	0.66	(203,968)	0.58
Expired	(482,091)	1.02	(41,500)	0.80
Outstanding, end of period	8,383,041	\$ 0.56	7,193,602	\$ 0.56
Options exercisable, end of period	6,267,541	\$ 0.51	6,060,574	\$ 0.53

As of September 30, 2010, the exercise prices, weighted average remaining contractual life and intrinsic values of outstanding options were as follows:

Exercise price	Options outstanding				Options exercisable			
	Number outstanding	Weighted average exercise price per share	Weighted average remaining contractual life (years)	Aggregate intrinsic value	Number exercisable	Weighted average exercise price per share	Aggregate intrinsic value	
\$0.31-\$0.49	3,691,087	\$ 0.38	2.8	\$ 1,063,006	3,691,087	\$ 0.38	\$ 1,063,006	
\$0.56-\$0.70	3,531,704	\$ 0.64	5.2	149,338	1,646,204	\$ 0.60	123,823	
\$0.80-\$0.99	1,160,250	\$ 0.86	3.3		930,250	\$ 0.86		
	8,383,041	\$ 0.56	3.9	\$ 1,212,344	6,267,541	\$ 0.51	\$ 1,186,829	

Total unrecognized compensation cost relating to unvested stock options at September 30, 2010, prior to the consideration of expected forfeitures, was approximately \$647,000 and is expected to be recognized over a weighted average period of 2.9 years.

The Company recorded stock-based compensation of \$155,570 and \$99,589 for the three months ended September 30, 2010 and 2009, respectively, and stock-based compensation of \$313,055 and \$231,297 for the nine months ended September 30, 2010 and 2009, respectively.

The Company has not capitalized any stock-based compensation expense as part of the cost of an asset.

(b) Restricted stock awards

Edgar Filing: TUCOWS INC /PA/ - Form 10-Q

During the three and nine months ended September 30, 2010, no restricted stock awards were granted to any employees of the Company.

Restricted stock awards generally vest annually over a four year period. Holders of restricted stock may not sell, assign, transfer, pledge or otherwise dispose of an unvested stock. Unvested shares of restricted stock are held in escrow by the Company until the holder's interest in such shares vests.

Holders of restricted stock have full stockholder rights with respect to any shares of Company stock issued to the participant under a stock award, whether or not the holder's interest in those shares is vested. Accordingly, the holder has the right to vote such shares and to receive any regular cash dividends paid on such shares.

Total unrecognized compensation cost relating to unvested restricted stock awards at September 30, 2010, prior to the consideration of expected forfeitures, was approximately \$2,000 and is expected to be recognized over a weighted average period of 2.5 years.

The Company recorded stock-based compensation associated with restricted stock awards of \$216 and \$221 for the three months ended September 30, 2010 and 2009, respectively.

The Company recorded stock-based compensation associated with restricted stock awards of \$633 and \$451 for the nine months ended September 30, 2010 and 2009, respectively.

Table of Contents**13. FAIR VALUE MEASUREMENT**

ASC Topic 820, *Fair Value Measurements and Disclosures* establishes a valuation hierarchy for disclosure of the inputs to valuation used to measure fair value. This hierarchy prioritizes the inputs into three broad levels. Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities. Level 2 inputs are quoted prices for similar assets and liabilities in active markets or inputs that are observable for the asset or liability, either directly or indirectly through market corroboration, for substantially the full term of the financial instrument. Level 3 inputs are unobservable inputs based on the Company's own assumptions used to measure assets and liabilities at fair value. A financial asset or liability's classification within the hierarchy is determined based on the lowest level input that is significant to the fair value measurement.

The following table provides a summary of the fair values of the Company's derivative instrument assets and liabilities measured at fair value on a recurring basis at September 30, 2010:

	September 30, 2010			Assets at Fair Value
	Level 1	Fair Value Measurements Using Level 2	Level 3	
Derivative instrument asset	\$	\$ 582,017	\$	\$ 582,017
Total Assets	\$	\$ 582,017	\$	\$ 582,017
Derivative instrument liability	\$	\$ (46,378)	\$	\$ (46,378)
Total Liabilities	\$	\$ (46,378)	\$	\$ (46,378)

The following table provides a summary of the fair values of the Company's derivative instrument assets measured at fair value on a recurring basis as at December 31, 2009:

	December 31, 2009			Assets at Fair Value
	Level 1	Fair Value Measurements Using Level 2	Level 3	
Derivative instrument asset	\$	\$ 2,220,378	\$	\$ 2,220,378
Total Assets	\$	\$ 2,220,378	\$	\$ 2,220,378
Derivative instrument liability	\$	\$ (15,708)	\$	\$ (15,708)
Total Liabilities	\$	\$ (15,708)	\$	\$ (15,708)

14. SUBSEQUENT EVENTS

On October 13, 2010, the Company announced that it successfully concluded a modified Dutch auction tender offer that was previously announced on September 9, 2010. Under the terms of the offer, the Company repurchased an aggregate of 3,913,670 shares of its common stock at a purchase price of \$0.70 per share, for a total of \$2,739,569, excluding transaction costs of \$50,000. The purchase price and all transaction costs were funded from available cash. All shares purchased in the tender offer received the same price and all shares repurchased were

Edgar Filing: TUCOWS INC /PA/ - Form 10-Q

immediately retired. As a result of the completion of the tender offer, as of October 13, 2010, the Company had 53,448,566 shares issued and outstanding.

On October 19, 2010, the Company entered into a Lease Extending and Amending Agreement on its Toronto, Canada office space as more fully described in the Form 8-K dated October 21 2010. The Lease Extending and Amending Agreement extends the term of the Lease for a period of nine years commencing on January 1, 2012 and expiring on December 31, 2020; and sets the Basic Rent (as defined in the Lease) for the period from January 1, 2011 to December 31, 2015 at \$17.50 per square foot, and sets the Basic Rent for the period from January 1, 2016 to December 31, 2020 at \$19.50 per square foot.

15. RECLASSIFICATION

Certain of the prior periods comparative figures have been reclassified to conform with the presentation adopted in the current period.

Table of Contents

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

This Quarterly Report on Form 10-Q contains, in addition to historical information, forward-looking statements by us with regard to our expectations as to financial results and other aspects of our business that involve risks and uncertainties and may constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Words such as may, should, anticipate, believe, plan, estimate, expect and intend, and other similar expressions are intended to identify forward-looking statements. The forward-looking statements contained in this report include statements regarding, among other things, the Company's foreign currency requirements, specifically for the Canadian dollar; the number of new, renewed and transferred-in domain names, our valuations of certain deferred tax assets, our expectation to collect our outstanding receivables, net of our allowance for doubtful accounts; the potential impact of current and pending claims on our business; our expectation regarding fluctuations in certain expense and cost categories; our expectations regarding future revenue from our patent assignments, our expectations regarding our unrecognized tax benefit and the timing or completion of certain audits of our US tax returns, our expectations regarding cash from operations to fund our business, our belief that the market for domain name registration will trend upward gradually and may be affected by market volatility; our belief that a slowing economy may lead to a decrease in advertising spending and the effect of changes in our contractual relationships on our revenue. These statements are based on management's current expectations and are subject to a number of uncertainties and risks that could cause actual results to differ materially from those described in the forward-looking statements. Many factors affect our ability to achieve our objectives and to successfully develop and commercialize our services including:

- Our ability to continue to generate sufficient working capital to meet our operating requirements;
- Our ability to maintain a good working relationship with our vendors and customers;
- The ability of vendors to continue to supply our needs;
- Actions by our competitors;
- Our ability to achieve gross profit margins at which we can be profitable;
- Our ability to attract and retain qualified personnel in our business;
- Our ability to effectively manage our business;

- Our ability to obtain and maintain approvals from regulatory authorities on regulatory issues;
- Pending or new litigation; and
- Factors set forth under the caption "Item 1A Risk Factors" in our Annual Report on Form 10-K for the fiscal year ended December 31, 2009.

This list of factors that may affect our future performance and financial and competitive position and also the accuracy of forward-looking statements is illustrative, but it is by no means exhaustive. Accordingly, all forward-looking statements should be evaluated with the understanding of their inherent uncertainty. All forward-looking statements included in this document are based on information available to us as of the date of this document, and we assume no obligation to update these cautionary statements or any forward-looking statements except to the extent of any obligations under the Securities Exchange Act of 1934 or the Securities Act of 1933. These statements are not guarantees of future performance.

We qualify all the forward-looking statements contained in this Form 10-Q by the foregoing cautionary statements.

OVERVIEW

Our mission is to provide simple useful services that help people unlock the power of the Internet. We accomplish this by reducing the complexity our customers experience as they acquire, deliver or use Internet services such as domain name registration, email and other Internet services.

Table of Contents

Our primary distribution channel is a global network of more than 10,000 resellers in more than 100 countries who typically provide their customers, the end-users of the Internet, with a critical component for establishing and maintaining an online presence. Our primary focus is serving the needs of this network of resellers by providing superior services, easy-to-use interfaces, proactive and attentive customer service, reseller-oriented technology and agile design and development processes. We seek to provide superior customer service to our resellers by anticipating their business needs and technical requirements. This includes providing easy-to-use interfaces that enable resellers to quickly and easily integrate our services into their individual business processes, and offering brandable end-user interfaces that emphasize simplicity and visual appeal. We also provide second tier support to our resellers by email and phone in the event resellers experience issues or problems with our services. In addition, our Network Operating Center provides proactive support to our resellers by monitoring all services and network infrastructure to address deficiencies before customer services are impacted.

We believe that the underlying platforms for our services are one of the most mature, reliable and functional reseller-oriented provisioning and management platforms in our industry, and we continue to refine, evolve and improve these services for both resellers and end-users.

To assist us in forecasting growth and to help us monitor the effectiveness of our operational strategies, we categorize our revenue into the following services:

OpenSRS, our wholesale service, manages over ten million domain names, under its ICANN accreditation, as well as names Tucows manages for other registrars under their own accreditations, millions of mailboxes and tens of thousands of digital certificates through a network of over 10,000 web hosts, Internet service providers, or ISPs, and other resellers around the world.

Platypus, our billing service, provides ISPs with an industry-specific solution for billing, service provisioning and customer account management.

Hover, our retail service, offers services similar to those of OpenSRS to consumers and small businesses.

YummyNames, our domain portfolio service, manages tens of thousands of domain names, most of which generate advertising revenue and many of which we offer for resale via our reseller network and other channels. Included in the YummyNames domain portfolio are over 42,000 domains that allow over two-thirds of Americans to purchase a domain or email address based on their name.

Butterscotch, our content service, operates two advertising-supported websites, butterscotch.com and tucows.com, which provide content to help consumers overcome the complexity of modern technology and the Internet, in the form of over 3,600 videos and over 300,000 software and mobile listings and articles. Additionally, Butterscotch provides custom video production services for technology manufacturers and ISPs.

Our business model is characterized by non-refundable, up-front payments, which lead to recurring revenue and positive operating cash flow. We are an ICANN-accredited registrar and manage over ten million domains under our ICANN accreditation, as well as names we manage for other registrars under their own accreditations.

Net Revenues

OpenSRS

We derive revenue from our reseller network by providing them with reseller services that comprise (a) domain service, (b) email service and (c) other services. Other services primarily consist of secure sockets layer, or SSL, certificates and also include blogware and website building tools that are used by our resellers to create bundles of Internet services for their end-users along with billing solutions for ISPs.

OpenSRS Domain Service

Historically, our OpenSRS domain service has constituted the largest portion of our business and encompasses all of our services as an accredited registrar related to the registration, renewal, transfer and management of domain names. In addition, this service fuels other revenue categories as it often is the initial service for which a customer will engage us, enabling us to follow on with other services and allowing us to add to our domain portfolio by purchasing names registered through us upon their expiration. We also provide resellers with the ability to sell personal names. This service allows resellers the opportunity to sell email addresses based on our domain portfolio of surname domain names.

Table of Contents

As of September 30, 2010, we offer registration services for the generic top-level domain (gTLDs) .com, .net, .org, .info, .name, .biz, .tel, .mobi and .asia and for the country code top-level domains (:ccTLDs) .at, .au, .be, .bz, .ca, .co, .cc, .ch, .cn, .de, .dk, .es, .eu, .fr, .in, .it, .li, .me, .mx, .nl, .tv, .uk, .ws, and .us.

With respect to the sale of domain registrations, our pricing structure for domain names provides visibility into the various fees that make up the cost of a domain name by breaking out the cost of the registry and ICANN fees separately from our management fee. Effective July 2010, registry fees for the .com and .net registrations were increased by the registry by an additional 7%. The management fee provides our resellers with access to our provisioning and management tools to enable them to register and administer domain names and access to additional services like WHOIS privacy and DNS services, enhanced domain name suggestion tools and access to our Premium Domain name services. We earn fees in connection with each new, renewed and transferred-in registration and from providing provisioning services to resellers and registrars on a monthly basis. Domain registrations are generally purchased for terms of one to ten years, with a majority having a one-year term. Except for certain large customers with whom we have negotiated alternative arrangements, payments for the full term of service, or billed revenue, is received at the time of activation of service. All fees received in connection with domain name registration are non-refundable, and where appropriate, are recorded as deferred revenue and recognized as earned ratably over the term of provision of service. This accounting treatment reasonably approximates a recognition pattern that corresponds with the provision of the services during the quarters and the year.

OpenSRS Email Service

We derive revenue from our hosted email service through our global distribution network. Our email service is offered on a per account, per month basis, and provides resellers with a reliable, scalable white label hosted email solutions that can be customized to their branding and business model requirements. The email service also includes spam and virus filtering on all accounts. End-users can access the email service via a full-featured, multi-language AJAX-enabled web interface, a WAP mobile interface, or through traditional desktop email clients, such as Microsoft Outlook or Apple Mail, using IMAP or POP/SMTP and 2GB of email storage.

We earn fees for email services when such services are activated. Email services are generally purchased monthly and, at month-end, are either deducted on a pre-authorized basis from reseller s deposit account, or are invoiced.

Other OpenSRS Services

We derive revenue from other services primarily from provisioning SSL certificates. In addition, we provision blogware and website building tools that are used by our resellers to create bundles of Internet services for their end-users, as well as the provision of billing, provisioning and customer care software solutions to ISPs through our Platypus billing software.

We earn fees from such services when a service is activated. These services are generally purchased for terms of one month to three years. Platypus software is generally purchased for terms of one month to one year. Payments for services are for the full term of all services at the time of activation of service, are non-refundable and, where appropriate, are recorded as deferred revenue and recognized as earned ratably over the service term. This accounting treatment reasonably approximates a recognition pattern that corresponds with the provision of the services during the quarters and the year.

YummyNames

We derive revenue from our portfolio of domain names by displaying advertising on the domains and by making them available for sale or lease. In addition we display advertising on parked pages within OpenSRS. Parked pages are domain names registered with us that do not yet contain an active website. When a user types one of these domain names into a web browser, they are presented with dynamically generated links that are pay-per-click advertising. Every time a user clicks on one of these links, it generates revenue for us through our partnership with third-parties who provide syndicated pay-per-click advertising.

Portfolio names are sold through our premium domain name service, auctions or in negotiated sales. The size of our domain name portfolio varies over time, as we acquire and sell domains on a regular basis to maximize the overall value and revenue generation potential of our portfolio. In evaluating names for sale, we consider the potential foregone revenue from pay-per-click advertising, as well as other factors. The name will be offered for sale if, based on our evaluation, the name is deemed non-essential to our business and management believes that deriving proceeds from the sale is strategically more beneficial to the Company.

Portfolio names that have been acquired from third-parties or through acquisition are included as intangible assets with indefinite lives on our consolidated balance sheet.

In addition, we also offer the same services to our customers, allowing them to make available names registered by them for monetization on a similar basis. For customer names, we earn a referral fee for premium names or names sold or leased, and participate on a revenue share basis for names offered through our pay-per-click advertising program.

Table of Contents

We recognize revenue from these services, net of any fees payable to resellers or customers, immediately upon completion of the service, or in the case of advertising revenue, on a monthly basis once the advertising has been served.

Hover

We derive revenues from the providing and managing Internet services, on a retail basis, to consumers and small businesses through our Hover.com website. These services include domain registration and other Internet services such as email and personalized email through our portfolio of surname-based domain names, as well as an easy-to-use interface that allows users to connect domain names to websites and email addresses through a unique DNS forwarding system. Depending on the service offered, we typically receive fees for our services.

Our customers generally purchase services for terms of one to ten years, with a majority of services purchased for a one-year term. Certain services are also offered on a monthly basis. Payments for the full term of all services, or billed revenue, are received at the time of service activation and, where appropriate, are recorded as deferred revenue and recognized as earned ratably over the term of provision of service. This accounting treatment reasonably approximates a recognition pattern that corresponds with the provision of the services during quarterly and annual periods.

Butterscotch

We also generate advertising and other revenue through two ad-supported content sites, butterscotch.com and tucows.com.

Butterscotch.com derives revenue from banner and text advertising on the site, as well as from video advertising and product placement within the videos that make up the bulk of the site. In addition, revenue is earned through custom video production for technology manufacturers and Internet services customers.

Tucows.com advertising revenue is generated from third-party advertisers and from software developers who rely on us as a primary source of distribution. Software developers use our Author Resource Center to submit their products for inclusion on our site and to purchase promotional placement of their software. Software developers may also purchase other promotional services on a cost-per-click or flat rate basis. Software developers are able to promote their software through advertising services including keyword search placements, banners, promotional placements, expedited reviews and premium data services. Revenue is also generated from companies that contract with us to provide them with co-branded content.

Advertising and other revenue is recognized ratably over the period in which it is presented. To the extent that we do not meet the minimum number of post-presentation impressions that we guarantee to customers, we defer recognition of the corresponding revenues until the guaranteed impressions are achieved. Custom video production revenue is recognized on acceptance of the completed video by the customer.

Critical Accounting Policies

The following is a discussion of our critical accounting policies and methods. Critical accounting policies are defined as those that are both important to the portrayal of our financial condition and results of operations and are reflective of significant judgments and uncertainties made by management that may result in materially different results under different assumptions and conditions. Note 2 to the consolidated financial statements for the year ended December 31, 2009, or Fiscal 2009, includes further information on the significant accounting policies and methods used in the preparation of our consolidated financial statements.

The preparation of financial statements in conformity with accounting principles generally accepted in the U.S. requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. On an on-going basis, we evaluate the application of these estimates, including those related to the useful lives and valuation of intangible assets, valuation of goodwill, fair value measurement of assets and liabilities, product development costs, revenue recognition and deferred revenue and accounting for income taxes. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual amounts could differ significantly from these estimates.

Revenue recognition policy

We earn revenues from the following services:

- OpenSRS (Domain, Email and Other Services);
- YummyNames;
- Hover; and
- Butterscotch.

Table of Contents

With respect to the sale of domain registrations and other Internet services, we earn registration fees in connection with each new, renewed and transferred-in registration and from providing provisioning services to resellers and registrars on a monthly basis. We also enter into revenue arrangements in which a reseller may purchase a combination of services (multiple element arrangements). When fair value exists for all elements, we allocate revenue to each element based on the relative fair value of each of the elements. Fair value is established by the price charged when that element is sold separately. For arrangements where fair value exists only for the undelivered elements, we defer the fair value of the undelivered elements and recognize the difference between the total arrangement fee and the amount deferred for the undelivered items as revenue related to the delivered items, assuming all other criteria for revenue recognition have been met. Payments for the full term of all services, or billed revenue, are received at the time of activation of service and where appropriate are recorded as deferred revenue and are recognized as earned ratably over the term of provision of service. This accounting treatment reasonably approximates a recognition pattern that corresponds with the provision of the services during the quarters and the year.

Revenue from the sale of domain names consists primarily of amounts earned for the transfer of rights to domain names that are currently under the Company's control. Collectability of revenues generated is subject to a high level of uncertainty; accordingly revenues are recognized only when payment is received, except where a fixed contract has been negotiated, in which case revenues are recognized once all the terms of the contract have been satisfied.

We also generate advertising and other revenue through our online libraries of shareware, freeware and online services presented at our websites, tucows.com and butterscotch.com. Advertising and other revenue is recognized ratably over the period in which it is presented. To the extent that the minimum number of post-presentation impressions we guarantee to customers is not met, we defer recognition of the corresponding revenues until the guaranteed impressions are achieved. Custom video production revenue is recognized on acceptance of the completed video by the customer.

Changes to contractual relationships in the future could impact the amounts and timing of revenue recognition.

In those cases where payment is not received at the time of sale, additional conditions for recognition of revenue apply. The conditions are (i) that the collection of sales proceeds is reasonably assured and (ii) that we have no further performance obligations. We record expected refunds, rebates and credit card charge-backs as a reduction of revenues at the time of the sale based on historical experiences and current expectations. Should these expectations not be met, adjustments will be required in future periods.

We establish reserves for possible uncollectible accounts receivable and other contingent liabilities which may arise in the normal course of business. The allowance for doubtful accounts is calculated by taking into account factors such as our historical collection and write-off experience, the number of days the customer is past due and the status of the customer's account with respect to whether or not the customer is continuing to receive service. The contingent liability estimates are based on management's historical experience and various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the reported amounts of liabilities and expenses that are not readily apparent from other sources. Historically, credit losses have been within our expectations and the reserves we have established have been appropriate. However, we have, on occasion, experienced issues which have led to accounts receivable not being fully collected. Should these issues occur more frequently, additional reserves may be required.

Valuation of Intangible Assets, Goodwill and Long-lived Assets

Edgar Filing: TUCOWS INC /PA/ - Form 10-Q

Goodwill represents the excess of purchase price over the fair values assigned to the net assets acquired in business combinations. Intangible assets consist of acquired technology, brand, customer relationships, non-competition agreements, surname domain names and direct navigation domain names. Intangible assets, which include technology, brand value, customer relationships and non-competition arrangements related to the acquisition of Boardtown Corporation in April 2004, the acquisition of the Hosted Messaging Business of Critical Path, Inc. in January 2006, the acquisition of Mailbank.com Inc. in June 2006 and the acquisition of Innerwise, Inc. in July 2007, are being amortized on a straight-line basis over periods of two to seven years.

Goodwill and indefinite life intangibles are not be amortized, but are tested for impairment annually or more frequently if circumstances indicate potential impairment, through a comparison of fair value to carrying amount. Goodwill and indefinite life intangibles are tested for impairment annually at the same time every year, and when an event occurs or circumstances change such that it is reasonably possible that impairment may exist. We review goodwill and indefinite life intangibles at least annually for possible impairment in the fourth quarter of each year.

We have other finite life intangible assets consisting of patented and non-patented technologies. These intangible assets are amortized over their expected economic lives. The lives are determined based upon the expected use of the asset, the estimated average life of the replacement parts of the reporting units products, the stability of the industry, expected changes in and replacement value of distribution networks and other factors deemed appropriate.

Table of Contents

With regards to property, equipment and definite life intangible assets, we continually evaluate whether events or circumstances have occurred that indicate the remaining estimated useful lives of its definite-life intangible assets may warrant revision or that the remaining balance of such assets may not be recoverable. We use an estimate of the related undiscounted cash flows over the remaining life of the asset in measuring whether the asset is recoverable. There was no impairment recorded on definite-life intangible assets and property and equipment during the three months ended September 30, 2010 or during the three months ended September 30, 2009.

Determining the number of reporting units and the fair value of a reporting unit requires us to make judgments and involves the use of significant estimates and assumptions. These estimates and assumptions include revenue growth rates and operating margins used to calculate projected future cash flows, risk-adjusted discount rates, future economic and market conditions, and determination of appropriate market comparables. We base our fair value estimates on assumptions we believe to be reasonable but that are unpredictable and inherently uncertain. The long-term financial forecast represents the best estimate that we have at this time and we believe that its underlying assumptions are reasonable. However, actual performance in the near-term and longer-term could be materially different from these forecasts, which could impact future estimates of fair value of our reporting units and may result in a charge to earnings in future periods due to the potential for a write-down of goodwill in connection with such tests.

Accounting for Income Taxes

We are subject to income taxes in the U.S. and numerous foreign jurisdictions. Significant judgment is required in evaluating our uncertain tax positions and determining our provision for income taxes. We apply a two-step approach to recognizing and measuring uncertain tax positions. The first step is to evaluate the tax position for recognition by determining if on the weight of available evidence; it is more likely than not that the position will be sustained on audit, including resolution of related appeals or litigation processes, if any. The second step is to measure the tax benefit that is more than 50% likely to be realized upon settlement.

Although we believe we have adequately reserved for our uncertain tax positions, no assurance can be given that the final tax outcome of these matters will not be different. We adjust these reserves in light of changing facts and circumstances, such as the closing of a tax audit or the refinement of an estimate. To the extent that the final tax outcome of these matters is different than the amounts recorded, such differences will impact the provision for income taxes in the period in which such determination is made.

As we account for income taxes under the asset and liability method, we recognize deferred tax assets or liabilities for the anticipated future tax effects of temporary differences between the financial statement basis and the tax basis of our assets and liabilities. We record a valuation allowance to reduce the net deferred tax assets when it is more likely than not that the benefit from the deferred tax assets will not be realized. In assessing the need for a valuation allowance, historical and future levels of income, expectations and risks associated with estimates of future taxable income and ongoing tax planning strategies are considered. In the event that it is determined that the deferred tax assets to be realized in the future would be in excess of the net recorded amount, an adjustment to the deferred tax asset valuation allowance would be recorded. This adjustment would increase income in the period that such determination was made. Likewise, should it be determined that all or part of a recorded net deferred tax asset would not be realized in the future, an adjustment to increase the deferred tax asset valuation allowance would be charged to income in the period that such determination would be made.

On a periodic basis, we evaluate the probability that our deferred tax assets will be recovered to assess its realizability. To the extent we believe it is more likely than not that some portion of our deferred tax assets will not be realized, we will increase the valuation allowance against the deferred tax assets. Realization of our deferred tax assets is dependent primarily upon future taxable income. Our judgments regarding future profitability may change due to future market conditions, changes in U.S. or international tax laws and other factors. These changes, if any, may

require possible material adjustments to these deferred tax assets, impacting net income or net loss in the period when such determinations are made.

Table of Contents**RESULTS OF OPERATIONS FOR THE THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2010 AS COMPARED TO THE THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2009**

The following table presents our net revenues, by revenue source:

	Three months ended September 30,		Nine months ended September 30,	
	2010	2009	2010	2009
OpenSRS :				
Domain Services	\$ 16,517,427	\$ 15,097,640	\$ 47,669,347	\$ 44,037,596
Email Services	577,606	842,262	1,796,452	2,838,052
Other Services	1,086,102	1,109,341	3,264,758	3,295,789
Total OpenSRS Services	18,181,135	17,049,243	52,730,557	50,171,437
YummyNames	1,249,128	1,781,725	4,592,297	5,102,315
Hover	1,147,576	1,203,742	3,388,036	3,763,155
Butterscotch	631,629	461,419	1,790,329	1,572,766
	\$ 21,209,468	\$ 20,496,129	\$ 62,501,219	\$ 60,609,673
Increase over comparative period	\$ 713,339		\$ 1,891,546	
Increase - percentage	3%		3%	

The following table presents our revenues, by revenue source, as a percentage of total revenues:

	Three months ended September 30,		Nine months ended September 30,	
	2010	2009	2010	2009
OpenSRS :				
Domain Services	78%	74%	77%	73%
Email Services	3%	4%	3%	5%
Other Services	5%	5%	5%	5%
Total OpenSRS Services	86%	83%	85%	83%
YummyNames	6%	9%	7%	8%
Hover	5%	6%	5%	6%
Butterscotch	3%	2%	3%	3%
	100%	100%	100%	100%

Deferred revenue from domain name registrations and other services at September 30, 2010 increased to \$62.3 million from \$56.5 million at September 30, 2009.

No customer accounted for more than 10% of revenue during the three and nine months ended September 30, 2010 and, at September 30, 2010, two customers accounted for 29% of accounts receivable all of which has been paid subsequent to September 30, 2010. Significant management judgment is required at the time revenue is recorded to assess whether the collection of the resulting receivables is reasonably assured. On an ongoing basis we assess the ability of our customers to make required payments. Based on this assessment, we expect the carrying amount of our outstanding receivables, net of allowance for doubtful accounts, to be fully collected.

OpenSRS

Net revenues from OpenSRS services for the three months ended September 30, 2010 as compared to the three months ended September 30, 2009, increased by \$1.1 million to \$18.2 million. This increase resulted from an increase in domain services revenue of \$1.4 million to \$16.5 million, primarily resulting from increased activity from our reseller base. In addition, OpenSRS services increased as we experienced an increase in registration fees paid to registries that were implemented in July 2010.

This increase in domain services revenue was partially offset by a decrease in email services revenue of \$0.3 million, primarily resulting from the loss of certain media portal email customers during 2009. Our marketing efforts to date have generated revenues that only partially offset these customer losses, which continue to adversely impact our results of operations for email services.

During the three months ended September 30, 2010, the number of transactions from all new, renewed and transferred-in domain name registrations that we processed increased by 0.2 million transactions to 1.8 million transactions as compared to the three months ended September 30, 2009. In addition, domain services revenue increased as we experienced an increase in registration fees paid to registries that were implemented in July 2010.

Net revenues from OpenSRS services for the nine months ended September 30, 2010 as compared to the nine months ended September 30, 2009, increased by \$2.6 million to \$52.7 million, primarily the result of domain services net revenues increasing by \$3.6 million to \$47.7 million being partially offset by email services decreasing by \$1.0 million for the reasons noted above.

Table of Contents

During the nine months ended September 30, 2010, the number of transactions from all new, renewed and transferred-in domain name registrations that we processed increased by 0.6 million transactions to 5.6 million transactions as compared to the nine months ended September 30, 2009. In addition, domain services revenue increased as we experienced an increase in registration fees paid to registries that were implemented in July 2010.

While we anticipate that the number of new, renewed and transferred-in domain name registrations will continue to incrementally increase, the volatility in the market could affect the growth of domain names that we manage. As of September 30, 2010, the total domain names under our management increased by 0.7 million to 8.7 million, when compared to September 30, 2009. In addition, we provide provisioning services on a monthly basis to accredited registrars who use our technical systems to process domain registrations with their own accreditation. As of September 30, 2010, we managed 1.7 million domain names on behalf of other accredited registrars, an increase of 0.5 million compared to the 1.2 million managed for accredited registrars as of September 30, 2009.

YummyNames

Net revenues from our YummyNames domain portfolio service for the three months ended September 30, 2010 as compared to the three months ended September 30, 2009 decreased by \$0.5 million, or 30%, to \$1.2 million.

During the three months ended September 30, 2010, we earned \$1.0 million by making domain names in our portfolio available for sale or lease compared to \$1.3 million during the three months ended September 30, 2009. In addition we earned \$0.3 million from our pay-per-click advertising or parked pages program during the three months ended September 30, 2010 compared to \$0.5 million for the three months ended September 30, 2009.

The decrease in portfolio sales primarily reflects the timing of larger portfolio sales of domain names and the decrease in the delivery of third-party advertisements on parked pages primarily resulted from the impact our sales of non-strategic names has on our inventory of names available for parking purposes.

Net revenues from our YummyNames domain portfolio service for the nine months ended September 30, 2010 as compared to the nine months ended September 30, 2009 decreased by \$0.5 million, or 10%, to \$4.6 million, primarily as a result of a \$0.7 million reduction in our pay-per-click advertising or parked pages revenue to \$1.0 million. This decrease was partially offset by an increase of \$0.2 million as a result of improved revenues from the sale of domain names from our portfolio.

The market for monetization of domain names is rapidly evolving and there is no guarantee that we will be able to continue to acquire the same caliber of names for our portfolio from future expiring domains or that names we acquire in future will provide the same revenue impact as we have experienced from past acquisitions. In addition, the revenue we derive from domain portfolio services is driven by general macroeconomic factors that affect internet advertising. Our advertising expenditures are typically sensitive to economic conditions and tend to decline in recessionary periods and other periods of economic uncertainty.

Hover

Net revenues from Hover for the three months ended September 30, 2010 as compared to the three months ended September 30, 2009 decreased by \$0.1 million, or 5%, to \$1.1 million.

Net revenues from Hover for the nine months ended September 30, 2010 as compared to the nine months ended September 30, 2009 decreased by \$0.4 million, or 10%, to \$3.4 million, primarily as a result of the significant development efforts that Hover undertook during Fiscal 2009. These development efforts resulted in a decrease in the deferred revenue balance during Fiscal 2009 as cash receipts added to deferred revenue during Fiscal 2009 were lower than the revenue being recognized from prior periods. Consequently, although cash receipts for the three and nine months ended September 30, 2010 increased as compared to the three and nine months ended September 30, 2009, net revenue decreased.

Butterscotch

Net revenues from Butterscotch for the three and nine months ended September 30, 2010 as compared to the three and nine months ended September 30, 2009 each increased by \$0.2 million respectively to \$0.6 million and \$1.8 million, respectively.

These increases are primarily the result of increases in video advertising and corporate video revenue as advertisers continue to migrate their advertising spend towards more content rich websites such as Butterscotch.com. This increase has been partially offset by the decline in our Author Resource Center revenues as advertisers continue to show a preference for more content rich traffic, as well as the significant decrease we have experienced in Ad Sense revenue, the result of Google's elimination of their enterprise level AdSense program.

Table of Contents

COST OF REVENUES

OpenSRS

OpenSRS Domain Service

Cost of revenues for domain registrations represents the amortization of registry fees on a basis consistent with the recognition of revenues from our customers, namely ratably over the term of provision of the service. Registry fees, the primary component of cost of revenues, are paid in full when the domain is registered, and are initially recorded as prepaid domain registry fees. This accounting treatment reasonably approximates a recognition pattern that corresponds with the provision of the services during the period.

OpenSRS Email Service

Cost of revenues for email services are payable to third-party providers for licensing and royalty costs related to the provision of certain components of our email services. Fees payable for these components are included in the cost of revenues in the month they are incurred.

Other OpenSRS Services

Costs of revenues for other reseller services include fees paid to third-party service providers, primarily for SSL certificates and for printing services in connection with Platypus. Fees payable for SSL certificates are amortized on a basis consistent with the provision of service, generally one year, while monthly printing fees are included in cost of revenues in the month they are incurred.

YummyNames

Costs of revenues for our domain portfolio service represent the amortization of registry fees for domains added to our portfolio over the renewal period, which is generally one year, the value attributed under intangible assets to any domain name sold and any impairment charges that may arise from our assessment of our domain name intangible assets. As the total names in our portfolio continue to grow, this cost will become a more significant component of our cost of revenues. Payments for domain registrations are payable for the full term of service at the time of activation of service and are recorded as prepaid domain registry fees and are expensed ratably over the renewal term.

Hover

Costs of revenues for our provision and management of Internet services on a retail basis include the amortization of registry fees on a basis consistent with the recognition of revenues from our customers, namely ratably over the term of provision of the service and includes the amortization of registry fees payable to renew the domains in our surname portfolio. Registry fees, the primary component of cost of revenues, are paid in full when the domain is registered, and are recorded as prepaid domain registry fees.

Butterscotch

Costs of revenues for our ad-supported content sites include the fees paid to third-party service providers, primarily for digital certificates sold through our content sites and content license fees.

Network costs

Network costs include personnel and related expenses, depreciation and amortization, communication costs, equipment maintenance, stock-based compensation and employee and related costs directly associated with the management and maintenance of our network. Communication costs include bandwidth, co-location and provisioning costs we incur to support the supply of all our services.

Edgar Filing: TUCOWS INC /PA/ - Form 10-Q

Table of Contents

The following table presents our cost of revenues, by revenue source:

	Three months ended September 30,		Nine months ended September 30,	
	2010	2009	2010	2009
OpenSRS :				
Domain Services	\$ 13,817,541	\$ 12,325,620	\$ 39,523,115	\$ 35,624,222
Email Services	97,001	103,071	321,459	436,216
Other Services	416,938	411,949	1,204,403	1,212,087
Total OpenSRS Services	14,331,480	12,840,640	41,048,977	37,272,525
YummyNames	179,894	218,371	636,389	654,456
Hover	380,262	493,181	1,129,996	1,481,761
Butterscotch	11,889	25,491	56,127	33,341
Network, other costs	1,087,930	1,193,185	3,500,826	3,500,231
Network, depreciation and amortization costs	306,055	376,818	1,018,774	1,404,583
	\$ 16,297,510	\$ 15,147,686	\$ 47,391,089	\$ 44,346,897
Increase over comparative period	\$ 1,149,824		\$ 3,044,192	
Increase - percentage	8%		7%	

The following table presents our cost of revenues, as a percentage of total revenues:

	Three months ended September 30,		Nine months ended September 30,	
	2010	2009	2010	2009
OpenSRS :				
Domain Services	66%	60%	63%	60%
Email Services	0%	1%	1%	1%
Other Services	2%	2%	2%	2%
Total OpenSRS Services	68%	63%	66%	63%
YummyNames	1%	1%	1%	1%
Hover	2%	2%	2%	2%
Butterscotch	0%	0%	0%	0%
Network, other costs	5%	6%	5%	6%
Network, depreciation and amortization costs	1%	2%	2%	1%
	77%	74%	76%	73%

Prepaid domain registration and other Internet services fees as of September 30, 2010 increased by \$5.9 million, or 13%, to \$49.5 million from \$43.6 million at September 30, 2009.

OpenSRS

Edgar Filing: TUCOWS INC /PA/ - Form 10-Q

Costs for OpenSRS for the three months ended September 30, 2010 increased by \$1.5 million, or 12%, to \$14.3 million, when compared to the three months ended September 30, 2009.

This increase was primarily the result of increased domain registration volumes and increases in registration fees paid to the registries that were implemented in July 2010 experienced during the three months ended September 30, 2010 when compared to the three months ended September 30, 2009.

Costs for OpenSRS for the nine months ended September 30, 2010 increased by \$3.8 million, or 10%, to \$41.0 million, when compared to the nine months ended September 30, 2009.

This increase was primarily a result of increased domain registration volume and increases in registration fees paid to the registries that were implemented in July 2010 experienced during the nine months ended September 30, 2010 when compared to the nine months ended September 30, 2009. This increase was partially offset by certain one-time email service costs we incurred during the nine months ended September 30, 2009.

YummyNames

Costs for YummyNames for the three and nine months ended September 30, 2010 as compared to the three and nine months ended September 30, 2009 remained relatively flat at \$0.2 million and \$0.6 million, respectively.

Hover

Costs for Hover for the three months ended September 30, 2010 as compared to the three months ended September 30, 2009 decreased by \$0.1 million, to \$0.4 million.

Table of Contents

Costs for Hover for the nine months ended September 30, 2010 as compared to the nine months ended September 30, 2009 decreased by \$0.4 million, to \$1.1 million.

These decreases resulted primarily from the introduction of new email service products, such as our family plan, which have resulted in a change in our sales mix such that email services, which have a relatively lower cost of sales, account for an increasing proportion of our Hover services as compared to our domain name services.

Network costs

Network costs before depreciation and amortization for the three months ended September 30, 2010 remained relatively flat at \$1.1 million as compared to the three months ended September 30, 2009, despite the significant strengthening, on average, of the Canadian dollar relative to the U.S. dollar by approximately 5% as compared to the three months ended September 30, 2009, and reflects our improved efficiency in operating and managing our co-location facilities.

Network costs before depreciation and amortization for the nine months ended September 30, 2010 remained relatively flat at \$3.5 million as compared to the nine months ended September 30, 2009, despite the significant strengthening, on average, of the Canadian dollar relative to the U.S. dollar by approximately 11% as compared to the nine months ended September 30, 2009, and reflects our improved efficiency in operating and managing our co-location facilities.

A significant portion of our operating and network expenses are incurred in Canadian dollars. As a result, the strengthening of the Canadian dollar relative to the U.S. dollar has negatively impacted all of our operating costs, during the three and nine months ended September 30, 2010 when compared to the three and nine months ended September 30, 2009. Exchange rates are, however, subject to significant and rapid fluctuations, and we therefore cannot predict the prospective impact of exchange rate fluctuations on our business, results of operations and financial condition.

Network depreciation and amortization costs for the three months ended September 30, 2010 decreased by \$0.1 million to \$0.3 million, primarily as a result of certain of our older computer hardware now being fully depreciated.

Network depreciation and amortization costs for the nine months ended September 30, 2010 decreased by \$0.4 million to \$1.1 million, primarily as a result of certain of our older computer hardware now being fully depreciated.

Excluding movements in exchange rates, we expect network costs to decrease slightly for the fiscal year ending December 31, 2010 as compared to the fiscal year ended December 31, 2009.

SALES AND MARKETING

Sales and marketing expenses consist primarily of personnel costs. These costs include commissions and related expenses of our sales, product management, public relations, call center, support and marketing personnel. Other sales and marketing expenses include customer acquisition costs, advertising and other promotional costs.

	Three months ended September 30,		Nine months ended September 30,	
	2010	2009	2010	2009
Sales and marketing	\$ 1,830,999	\$ 1,568,727	\$ 5,480,228	\$ 4,261,070
Increase over comparative period	\$ 262,272		\$ 1,219,158	
Increase - percentage	17%		29%	
Percentage of net revenues	9%	8%	9%	7%

Sales and marketing expenses for the three months ended September 30, 2010 increased by \$0.3 million, or 17%, to \$1.6 million when compared to the three months ended September 30, 2009. This increase was primarily due to higher workforce costs that resulted from additional people employed in both our marketing and customer service areas as well as the negative impact of the approximately 5% strengthening, on average, in the Canadian dollar relative to the U.S. dollar compared to the three months ended September 30, 2009.

Sales and marketing expenses for the nine months ended September 30, 2010 increased by \$1.2 million, or 29%, to \$5.5 million when compared to the nine months ended September 30, 2009. This increase was primarily due to higher workforce costs that resulted from an increase in the number of people employed in both our marketing and customer service departments, undertaking additional marketing campaigns, participating in additional trade shows and the negative impact of the approximate 11% strengthening, on average, in the Canadian dollar relative to the U.S. dollar compared to the nine months ended September 30, 2009.

Included in sales and marketing expenses for the nine months ended September 30, 2010 is a non-recurring cost of approximately \$0.1 million related to severance costs.

Table of Contents

Excluding movements in exchange rates, we expect sales and marketing expenses to increase slightly during Fiscal 2010, in absolute dollars, as we adjust our marketing programs and sales and customer support strategies to meet future opportunities in the marketplace.

TECHNICAL OPERATIONS AND DEVELOPMENT

Technical operations and development expenses consist primarily of personnel costs and related expenses required to support the development of new or enhanced service offerings and the maintenance and upgrading of existing infrastructure. This includes expenses incurred in the research, design and development of technology that we use to register domain names, email, retail, domain portfolio and other Internet services, as well as to distribute our digital content services. Editorial costs relating to the rating and review of the software content libraries are included in the costs of product development. Costs incurred during the application development stage are capitalized and primarily include personnel costs for employees directly related to the development project. As no material expenditures for qualified application development stage initiatives were incurred during the three or nine months ended September 31, 2010 or September 30, 2009, no amounts have been capitalized. All other costs are expensed as incurred.

	Three months ended September 30,		Nine months ended September 30,	
	2010	2009	2010	2009
Technical operations and development	\$ 1,053,768	\$ 1,142,331	\$ 3,486,718	\$ 3,421,825
(Decrease) increase over comparative period	\$ (88,563)		\$ 64,893	
(Decrease) increase - percentage	(8)%		2%	
Percentage of net revenues	5%	6%	6%	6%

Technical operations and development expenses for the three months ended September 30, 2010 remained relatively flat at \$1.1 million when compared to the three months ended September 30, 2009, primarily due to the productivity improvements that have resulted from our adoption of an agile development model, which deploys our development, quality assurance, product management and operations employees into smaller teams, offsetting the approximate 5% strengthening, on average, in the Canadian dollar relative to the U.S. dollar when compared to the three months ended September 30, 2009.

Technical operations and development expenses for the nine months ended September 30, 2010 increased by \$0.1 million, or 2%, to \$3.5 million when compared to the nine months ended September 30, 2009, primarily due to the increase in workforce-related costs, including contract and outside service cost increases and the approximate 11% strengthening, on average, in the Canadian dollar relative to the U.S. dollar when compared to the nine months ended September 30, 2009.

Excluding movements in exchange rates, we expect technical operations and development expenses, in absolute dollars, for the fiscal year ending December 31, 2010 to remain relatively flat when compared to the fiscal year ended December 31, 2009.

GENERAL AND ADMINISTRATIVE

Edgar Filing: TUCOWS INC /PA/ - Form 10-Q

General and administrative expenses consist primarily of compensation and related costs for managerial and administrative personnel, fees for professional services, public listing expenses, rent and other general corporate expenses.

	Three months ended September 30,		Nine months ended September 30,	
	2010	2009	2010	2009
General and administrative	\$ 633,457	\$ 1,145,951	\$ 2,049,813	\$ 4,608,173
Decrease over comparative period	\$ (512,494)		\$ (2,558,360)	
Decrease - percentage	(45)%		(56)%	
Percentage of net revenues	3%	6%	3%	8%

General and administrative expenses for the three months ended September 30, 2010 decreased by \$0.5 million, or 45%, to \$0.6 million as compared to the three months ended September 30, 2009. This was primarily as a result of our recording a foreign exchange gain of \$0.6 million during the three months ended September 30, 2010 as compared to a foreign exchange gain of \$48,000 during the three months ended September 30, 2009. This gain in foreign exchange was primarily the result of the strengthening, on average, of the Canadian dollar relative to the U.S. dollar by approximately 5% from the three months ended September 30, 2009. This decrease was offset mainly by an increase in professional fees of \$0.1 million during the three months ended September 30, 2010, as compared to the three months ended September 30, 2009.

Table of Contents

General and administrative expenses for the nine months ended September 30, 2010 decreased by \$2.6 million, or 56%, to \$2.0 million as compared to the nine months ended September 30, 2009. This was primarily as a result of our recording a foreign exchange gain of \$1.9 million during the nine months ended September 30, 2010 as compared to a foreign exchange loss of \$1.0 million during the nine months ended September 30, 2009. This gain in foreign exchange was primarily the result of the strengthening, on average, of the Canadian dollar relative to the U.S. dollar by approximately 11% from the nine months ended September 30, 2009. This decrease was offset mainly by an increase in workforce related costs, facility costs and professional services of \$0.4million during the nine months ended September 30, 2010, as compared to the nine months ended September 30, 2009.

DEPRECIATION OF PROPERTY AND EQUIPMENT

Property and equipment is depreciated on a straight-line basis over the estimated useful life of the assets.

	Three months ended September 30,		Nine months ended September 30,	
	2010	2009	2010	2009
Depreciation of property and equipment	\$ 40,239	\$ 47,249	\$ 127,559	\$ 221,937
Decrease over comparative period	\$ (7,010)		\$ (94,378)	
Decrease - percentage	(15)%		(43)%	

Depreciation costs for the three months ended September 30, 2010 decreased by \$7,000, or 15%, to \$40,000, primarily as a result of certain of our older assets being fully depreciated.

Depreciation costs for the nine months ended September 30, 2010 decreased by \$94,000, or 43%, to \$128,000, primarily as a result of certain of our older assets being fully depreciated.

LOSS ON DISPOSITION OF PROPERTY AND EQUIPMENT

	Three months ended September 30,		Nine months ended September 30,	
	2010	2009	2010	2009
Loss on disposition of property and equipment	\$	\$ 40,369	\$	\$ 40,369

As part of our ongoing initiatives to improve the efficiency of our production environment, we retired some older computer hardware at our co-location facilities during the three months ended September 30, 2009, which resulted in a loss of \$40,000 on the disposition of such equipment.

AMORTIZATION OF INTANGIBLE ASSETS

Edgar Filing: TUCOWS INC /PA/ - Form 10-Q

	Three months ended September 30,		Nine months ended September 30,	
	2010	2009	2010	2009
Amortization of intangible assets	\$ 360,540	\$ 360,540	\$ 1,081,620	\$ 1,081,620

Amortization of intangible assets consists of amounts arising in connection with the acquisition of Boardtown in April 2004, the acquisition of the hosted messaging assets of Critical Path Inc. in January 2006, the acquisition of Mailbank.com Inc. in June 2006 and the acquisition of IYD in July 2007.

Brand and customer relationships acquired in connection with the acquisition of Boardtown Corporation and IYD are amortized on a straight-line basis over seven years.

Customer relationships acquired in connection with the acquisition of Mailbank.com Inc. and the hosted messaging assets of Critical Path Inc. are each amortized on a straight-line basis over five years.

Table of Contents**LOSS (GAIN) ON CHANGE IN FAIR VALUE OF FORWARD EXCHANGE CONTRACTS**

Although our functional currency is the U.S. dollar, a major portion of our fixed expenses are incurred in Canadian dollars. Our goal with regard to foreign currency exposure is, to the extent possible, to achieve operational cost certainty, manage financial exposure to certain foreign exchange fluctuations and to neutralize some of the impact of foreign currency exchange movements. Accordingly, we enter into foreign exchange contracts to mitigate the exchange rate risk on portions of our Canadian dollar exposure.

As we are not required to comply with the documentation requirements for hedge accounting, we account for the fair value of the derivative instruments within the consolidated balance sheet as a derivative financial asset or liability and the corresponding change in fair value is recorded in the consolidated statement of operations.

	Three months ended September 30,		Nine months ended September 30,	
	2010	2009	2010	2009
(Gain) loss on change in fair value of forward contracts	\$ (141,981)	\$ (1,878,230)	\$ 1,669,031	\$ (3,902,394)
Decrease over comparative period	\$ 1,736,249		\$ 5,571,425	
Decrease - percentage	(92)%		(143)%	
Percentage of net revenues	(1)%	-9%	3%	-6%

We have entered into forward exchange contracts to meet a portion of our future Canadian dollar requirements through November 2011. The impact of the fair value adjustment on unrealized foreign exchange on these contracts for the three months ended September 30, 2010 was a net gain of \$0.1 million, as compared to a net gain of \$1.9 million for the three months ended September 30, 2009. This net gain in fair value of forward contracts resulted from the impact of the change in foreign exchange rates over time and the settlement of forward exchange contracts as they matured.

The impact of the fair value adjustment on unrealized foreign exchange on these contracts for the nine months ended September 30, 2010 was a net loss of \$1.7 million, as compared to a net gain of \$3.9 million for the nine months ended September 30, 2009. This net loss in fair value of forward contracts resulted from the impact of the change in foreign exchange rates over time and the settlement of forward exchange contracts as they matured.

At September 30, 2010, we reflect a net derivative instrument asset of \$0.5 million on our balance sheet as a result of our foreign exchange contracts. Until their respective maturity dates, these contracts will fluctuate in value in line with movements in the Canadian vs. U.S. dollar pair. As all of the remaining contracts pertaining to the 2010 fiscal year will have matured during the course of the 2010 fiscal year, a derivative instrument asset pertaining to 2010 fiscal year contracts of \$0.3 million will reverse during the three months ending December 31, 2010 and will result in our recognizing an additional non-cash loss of this amount. This loss may, however, be impacted by any additional contracts, with maturity dates after September 30, 2010, that we may enter into and fluctuations in the value of our existing contracts that mature.

OTHER INCOME AND EXPENSES

Edgar Filing: TUCOWS INC /PA/ - Form 10-Q

	Three months ended September 30,		Nine months ended September 30,	
	2010	2009	2010	2009
Other income (expenses), net	\$ (26,917)	\$ 1,827,113	\$ (99,812)	\$ 4,314,521
Increase over comparative period	\$ (1,854,030)		\$ (4,414,333)	
Increase - percentage	(101)%		(102)%	
Percentage of net revenues		%	9%	%

Other expenses for the three and nine months ended September 30, 2010 primarily relate to interest payable pursuant to the terms of our Amended Credit Facility. As we have continued to reduce the amount outstanding under our Amended Credit Facility through monthly principal payments, the interest payable has decreased when compared to the three and nine months ended September 30, 2009.

Other income for the three and nine months ended September 30, 2009 also included the receipt in April 2009 of \$2.1 million from Afilias Inc. (Afilias) to complete the second closing under the terms of a stock redemption agreement signed in November 2008, and an amount of \$2.0 million in September 2009 to complete the third and final closing in September 2009.

In addition, in June 2009, we received an additional payment of \$0.6 million in connection with Infonautics patents that we assigned in 2002 to a third party who continues to commercialize these patents. In connection with the assignment of these patents, we retained the right to share in certain revenue relating to any cash flow received by such third party. As the costs of commercializing the patents have increased, we do not expect any future revenue received to be material.

Table of Contents**INCOME TAXES**

The following table presents our provision for income taxes for the periods presented:

	Three months ended September 30,		Nine months ended September 30,	
	2010	2009	2010	2009
Provision for income taxes	\$ 24,863	\$ (447,455)	\$ 235,105	\$ 241,621

For the nine months ended September 30, 2010, we recorded a provision for income taxes of \$0.2 million on income before income taxes of \$1.1 million, using an estimated effective tax rate for our 2010 fiscal year adjusted for certain foreign exchange losses that we do not anticipate obtaining a current tax benefit for. Included in the provision for income taxes is a recovery of \$0.1 million in respect of refundable Ontario research tax credits. Comparatively, for the nine months ended September 30, 2009, we recorded a current tax expense of \$0.2 million on income before income taxes of 10.8 million, using an estimated effective tax rate for our 2009 fiscal year that accounts for the utilization of remaining net operating loss carry forwards and alternative minimum tax credits available to us.

As of December 31, 2009, we recorded a valuation allowance of \$4.3 million and a net deferred tax asset of \$3.0 million. As of September 30, 2010 we had recorded a non-current deferred tax asset of \$3.9 million and current deferred tax liabilities of \$0.9 million. As of September 30, 2010 and December 31, 2009, we had also recorded a non current deferred tax liability related to the temporary difference arising on indefinite life intangibles of \$4.8 million.

We analyze the carrying value of our deferred tax asset on a regular basis. In determining future taxable income, assumptions are made to forecast federal, state and international operating income, the reversal of temporary timing differences, and the implementation of any feasible and prudent tax planning strategies. The assumptions require significant judgment regarding the forecasts of future taxable income, and are consistent with other forecasts used to manage the business. During the nine months ended September 30, 2010, there was no reversal of the valuation allowance. The valuation allowance will be maintained until sufficient evidence exists to support a reversal of, or decrease in, the valuation allowance.

We follow the provisions of FASB ASC Topic 740, Income Taxes to account for income tax exposures. The application of this interpretation requires a two-step process that separates recognition of uncertain tax benefits from measurement thereof.

We have approximately \$0.1 million of total gross unrecognized tax benefit as of September 30, 2010 and \$0.1 million of total gross unrecognized tax benefit as of December 31, 2009, which if recognized would favorably affect our income tax rate in future periods. The unrecognized tax benefit relates primarily to prior year Pennsylvania state franchise taxes and other insignificant US state taxes. The unrecognized tax benefit has decreased by \$17,000 when compared to the gross unrecognized tax benefits as of December 31, 2009 as we have now settled the claim for the Pennsylvania franchise taxes for the years December 31, 1996 to December 31, 2000. We do not expect the unrecognized tax benefit for our 2010 research and development claim to be significant. We recognize accrued interest and penalties related to taxes in tax expense. We did not have significant interest and penalties accrued as of September 30, 2010 and December 31, 2009, respectively. We believe it is reasonably possible that \$0.1 million of the unrecognized tax benefit will decrease in the next twelve months as it is anticipated that the U.S. tax authorities will finalize their review of prior taxes owing in Pennsylvania within the period and certain other prior year state tax returns will be filed.

Table of Contents

LIQUIDITY AND CAPITAL RESOURCES

As of September 30, 2010, our principal sources of liquidity were cash flows generated from operations and cash and cash equivalents of \$5.4 million, as compared to \$9.6 million at December 31, 2009.

Net cash provided by operating activities for the nine months ended September 30, 2010 increased by \$0.8 million to \$4.4 million, as compared to \$3.6 million for the nine months ended September 30, 2009.

Net cash provided by operating activities, before changes in non-cash operating working capital, decreased by \$0.4 million to \$4.9 million for the nine months ended September 30, 2010 from \$5.3 million for the nine months ended September 30, 2009. Net cash utilized by changes in non-cash operating working capital, decreased by \$1.2 million to \$0.5 million for the nine months ended September 30, 2010 compared to a decrease of \$1.7 million for the nine months ended September 30, 2009.

This improvement in non-cash working capital was primarily the result of reductions in accounts receivable, deposits we maintain with our registry suppliers and income taxes recoverable, and an increase in accounts payable of \$1.2 million during the nine months ended September 30, 2010, as compared to the nine months ended September 30, 2009. In addition, deferred revenue, net of prepaid domain name registry and other Internet services fees, increased by \$0.5 million, as compared to the nine months ended September 30, 2009. These improvements were partially offset by an increase in accruals and customer deposits of \$0.6 million, as compared to the nine months ended September 30, 2009.

Net cash used in financing activities during the nine months ended September 30, 2010 totaled \$8.3 million as compared to \$4.5 million for the nine months ended September 30, 2009. Of this \$8.3 million, \$6.9 million was used to fund share repurchases as described in the following paragraph and \$1.4 million was used for principal repayments under our Amended Credit Facility.

We used \$4.5 million to repurchase 6.3 million of our shares pursuant to the terms of a Dutch auction tender offer completed during January 2010 and \$2.4 million to repurchase 3.4 million of our shares under the terms of our stock repurchase program announced in February 2010. These initiatives have resulted in a 15 % reduction in our issued and outstanding shares as compared to our issued and outstanding shares at December 31, 2009. In connection with the amendment of our credit facility, the Bank has waived the cash sweep payment based on our audited results for the year ended December 31, 2009. As a result, we have continued to make equal monthly principal repayments of approximately \$160,000, for an aggregate payment during the nine months ended September 30, 2010 of \$1.4 million. This has reduced the balance owing under the Amended Credit Facility as of September 30, 2010 to \$1.8 million.

Investing activities used net cash of \$0.3 million to acquire additional property and equipment during the nine months ended September 30, 2010, as compared to the \$3.7 million in cash provided by investing activities during the nine months ended September 30, 2009. This provision of cash during the nine months ended September 30, 2009 resulted from our receipt of \$4.1 million in proceeds from the disposition of our investment in Afiliat, which was partially offset by \$0.4 million invested to acquire additional property and equipment during the nine months ended September 30, 2009.

Edgar Filing: TUCOWS INC /PA/ - Form 10-Q

Based on our operations, we believe that our cash flow from operations will be adequate to meet our anticipated requirements for working capital, capital expenditures and our loan repayments for at least the next 12 months.

We may choose to raise additional funds or seek other financing arrangements to facilitate more rapid expansion, develop new or enhance existing products or services, respond to competitive pressures or acquire or invest in complementary businesses, technologies, services or products.

If additional financing is required, we may not be able to raise it on acceptable terms, or at all, and additional financing may be dilutive to existing investors. We may also evaluate potential acquisitions of other businesses, products and technologies. To complete potential acquisitions, we may issue additional securities or need additional equity or debt financing and any additional financing may be dilutive to existing investors. There are currently no material understandings, commitments or agreements regarding the acquisition of other businesses.

Table of Contents**Item 3. Quantitative and Qualitative Disclosures About Market Risk**

We develop products in Canada and sell these services in North America and Europe. Our sales are primarily made in U.S. dollars, while a major portion of expenses are incurred in Canadian dollars. Our financial results could be affected by factors such as changes in foreign currency exchange rates or weak economic conditions in foreign markets. Our interest income is sensitive to changes in the general level of Canadian and U.S. interest rates, particularly since the majority of our investments are in short-term instruments. Based on the nature of our short-term investments, we have concluded that there is no material interest rate risk exposure as of September 30, 2010. We are also subject to market risk exposure related to changes in interest rates under our Amended Credit Facility. We do not expect that any changes in interest rates will be material, however, fluctuations in interest rates are beyond our control. We will continue to monitor and assess the risks associated with interest expense exposure and may take additional actions in the future to mitigate these risks.

Although our functional currency is the U.S. dollar, a substantial portion of our fixed expenses are incurred in Canadian dollars. Our policy with respect to foreign currency exposure is to manage financial exposure to certain foreign exchange fluctuations with the objective of neutralizing some of the impact of foreign currency exchange movements. Exchange rates are, however, subject to significant and rapid fluctuations, and therefore we cannot predict the prospective impact of exchange rate fluctuations on our business, results of operations and financial condition. Accordingly, we have entered into foreign exchange contracts to mitigate the exchange rate risk on portions of our Canadian dollar exposure.

At September 30, 2010, the Company had the following outstanding forward exchange contracts to trade U.S. dollars in exchange for Canadian dollars:

Maturity date	Notional amount of U.S. dollars	Weighted average exchange rate of U.S. dollars	Fair value
October - December 2010	5,400,000	0.9236	280,870
2010	5,400,000	0.9236	280,870
January - March 2011	5,400,000	0.9307	225,103
April - June 2011	3,900,000	0.9635	14,779
June - September 2011	3,900,000	0.9604	17,896
October - December 2011	1,950,000	0.9644	(3,009)
2011	15,150,000	0.9508	254,769
Total	\$ 20,550,000	0.9435	\$ 535,639

During the nine months ended September 30, 2010, the Company entered into a series of foreign exchange forward contracts to hedge a portion of our 2011 fiscal year expected Canadian dollar requirements. These contracts, collectively, have a notional value of US\$10.0 million, whereby amounts of US\$250,000, US\$400,000 or US\$650,000 are converted into Canadian dollars on a semi-monthly basis from January 2011 to November 2011 at an average foreign exchange rate of US\$1.00: Cdn\$1.0437.

The Company does not apply hedge accounting and, therefore, for the three and nine months ended September 30, 2010, the Company recorded a gain of \$0.1 million and a loss of \$1.7 million respectively, in the fair value of forward contracts in its consolidated statements of operations.

Edgar Filing: TUCOWS INC /PA/ - Form 10-Q

For the three and nine months ended September 30, 2009, the Company recorded a gain on forward contracts of \$1.9 million and \$2.9 million respectively.

We have performed a sensitivity analysis model for foreign exchange exposure over the three months ended September 30, 2010. The analysis used a modeling technique that compares the U.S. dollar equivalent of all expenses incurred in Canadian dollars, at the actual exchange rate, to a hypothetical 10% adverse movement in the foreign currency exchange rates against the U.S. dollar, with all other variables held constant. Foreign currency exchange rates used were based on the market rates in effect during the three months ended September 30, 2010. The sensitivity analysis indicated that a hypothetical 10% adverse movement in foreign currency exchange rates would result in a decrease in net income for the three months ended September 30, 2010 of approximately \$0.4 million. There can be no assurances that the above projected exchange rate decrease will materialize. Fluctuations of exchange rates are beyond our control. We will continue to monitor and assess the risk associated with these exposures and may take additional actions in the future to hedge or mitigate these risks.

Table of Contents

Credit Risk

Financial instruments that potentially subject us to concentrations of credit risk consist principally of cash equivalents, marketable securities, foreign exchange contracts and accounts receivable. Our cash, cash equivalents and short-term investments are in high-quality securities placed with major banks and financial institutions whom we have evaluated as highly creditworthy and commercial paper. With respect to accounts receivable, we perform ongoing evaluations of our customers, generally granting uncollateralized credit terms to our customers, and maintaining an allowance for doubtful accounts based on historical experience and our expectation of future losses.

Item 4. Controls and Procedures

(a) Evaluation of Disclosure Controls and Procedures

Our management, with the participation of our chief executive officer and chief financial officer, evaluated the effectiveness of our disclosure controls and procedures as of the end of the period covered by this report. Based on that evaluation, our chief executive officer and chief financial officer concluded that our disclosure controls and procedures as of the end of the period covered by this report have been designed and are functioning effectively to provide reasonable assurance that the information required to be disclosed by us in reports filed under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and is accumulated and communicated to our management, including our principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure. We believe that a controls system, no matter how well designed and operated, cannot provide absolute assurance that the objectives of the controls system are met, and no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within a company have been detected.

(b) Change in Internal Control over Financial Reporting

No change in our internal control over financial reporting occurred during our most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

**PART II.
OTHER INFORMATION**

Item 1. Legal Proceedings

We are involved in various investigations, claims and lawsuits arising in the normal conduct of our business, none of which, in our opinion, will harm our business. We cannot assure that we will prevail in any litigation. Regardless of the outcome, any litigation may require us to incur

significant litigation expense and may result in significant diversion of our attention.

Item 1A. Risk factors

In addition to the other information set forth in this Quarterly Report, you should also carefully consider the risk factors discussed in Part I, Item 1A. Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2009, all of which could materially affect our business, financial condition or operating results and should be considered before making an investment decision regarding our securities. The risks described in our Annual Report on Form 10-K are not the only risks facing the Company. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may adversely affect our business, financial condition or operating results.

Table of Contents

Item 6. Exhibits

(a) Exhibits.

Exhibit No.	Description
3.1	Fourth Amended and Restated Articles of Incorporation of Tucows Inc. (Incorporated by reference to Exhibit 3.1 filed with Tucows' current report on Form 8-K, as filed with the SEC on November 29, 2007)
3.2	Second Amended and Restated Bylaws of Tucows Inc. (Incorporated by reference to Exhibit 3.2 filed with Tucows' annual report on Form 10-K for the year ended December 31, 2006, as filed with the SEC on March 29, 2007)
10.1	Operating Loan Agreement, dated September 10, 2010, between Tucows.com Co. and the Bank of Montreal (incorporated herein by reference to Exhibit 10.1 to Tucows Inc.'s Current Report on Form 8-K, filed with the Securities and Exchange Commission on September 13, 2010).
10.2	Offer Letter, dated August 30, 2010, between Tucows Inc. and the Bank of Montreal (incorporated herein by reference to Exhibit 10.2 to Tucows Inc.'s Current Report on Form 8-K, filed with the Securities and Exchange Commission on September 13, 2010).
10.3	Loan Agreement, dated as of June 25, 2007, by and among Tucows.com Co., Tucows (Delaware) Inc., Tucows Inc., Mailbank Nova Scotia Co., Tucows Domain Holdings Co., Innerwise, Inc. and Bank of Montreal (incorporated herein by reference to Exhibit 10.1 to Tucows Inc.'s Current Report on Form 8-K, filed with the Securities and Exchange Commission on July 31, 2007).
10.4	Guaranty, dated July 25, 2007, by Tucows Inc. in favor of the Bank of Montreal (incorporated herein by reference to Exhibit 10.2 to Tucows Inc.'s Current Report on Form 8-K, filed with the Securities and Exchange Commission on July 31, 2007).
10.5	Security Agreement, dated July 25, 2007, by Tucows Inc. in favor of the Bank of Montreal (incorporated herein by reference to Exhibit 10.3 to Tucows Inc.'s Current Report on Form 8-K, filed with the Securities and Exchange Commission on July 31, 2007).
10.6	Lease Extending and Amending Agreement, executed as of October 19, 2010, effective as of September 17, 2010, between 707932 Ontario Limited, Tucows (Delaware) Inc. and Tucows.com Co. (incorporated herein by reference to Exhibit 10.1 to Tucows Inc.'s Current Report on Form 8-K, filed with the Securities and Exchange Commission on September 13, 2010).
31.1	Chief Executive Officer's Rule 13a-14(a)/15d-14(a) Certification *
31.2	Chief Financial Officer's Rule 13a-14(a)/15d-14(a) Certification *
32.1	Chief Executive Officer's Section 1350 Certification
32.2	Chief Financial Officer's Section 1350 Certification

* Filed herewith.

Furnished herewith.

Table of Contents

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Date: November 12, 2010

TUCOWS INC.

By: /s/ Elliot Noss
Elliot Noss
President and Chief Executive Officer

By: /s/ Michael Cooperman
Michael Cooperman Chief Financial Officer
(Principal Financial and Accounting Officer)

Table of Contents

EXHIBIT INDEX

Exhibit No	Description
3.1	Fourth Amended and Restated Articles of Incorporation of Tucows Inc. (Incorporated by reference to Exhibit 3.1 filed with Tucows' current report on Form 8-K, as filed with the SEC on November 29, 2007)
3.2	Second Amended and Restated Bylaws of Tucows Inc. (Incorporated by reference to Exhibit 3.2 filed with Tucows' annual report on Form 10-K for the year ended December 31, 2006, as filed with the SEC on March 29, 2007)
10.1	Operating Loan Agreement, dated September 10, 2010, between Tucows.com Co. and the Bank of Montreal (incorporated herein by reference to Exhibit 10.1 to Tucows Inc.'s Current Report on Form 8-K, filed with the Securities and Exchange Commission on September 13, 2010).
10.2	Offer Letter, dated August 30, 2010, between Tucows Inc. and the Bank of Montreal (incorporated herein by reference to Exhibit 10.2 to Tucows Inc.'s Current Report on Form 8-K, filed with the Securities and Exchange Commission on September 13, 2010).
10.3	Loan Agreement, dated as of June 25, 2007, by and among Tucows.com Co., Tucows (Delaware) Inc., Tucows Inc., Mailbank Nova Scotia Co., Tucows Domain Holdings Co., Innerwise, Inc. and Bank of Montreal (incorporated herein by reference to Exhibit 10.1 to Tucows Inc.'s Current Report on Form 8-K, filed with the Securities and Exchange Commission on July 31, 2007).
10.4	Guaranty, dated July 25, 2007, by Tucows Inc. in favor of the Bank of Montreal (incorporated herein by reference to Exhibit 10.2 to Tucows Inc.'s Current Report on Form 8-K, filed with the Securities and Exchange Commission on July 31, 2007).
10.5	Security Agreement, dated July 25, 2007, by Tucows Inc. in favor of the Bank of Montreal (incorporated herein by reference to Exhibit 10.3 to Tucows Inc.'s Current Report on Form 8-K, filed with the Securities and Exchange Commission on July 31, 2007).
10.6	Lease Extending and Amending Agreement, executed as of October 19, 2010, effective as of September 17, 2010, between 707932 Ontario Limited, Tucows (Delaware) Inc. and Tucows.com Co. (incorporated herein by reference to Exhibit 10.1 to Tucows Inc.'s Current Report on Form 8-K, filed with the Securities and Exchange Commission on September 13, 2010).
31.1	Chief Executive Officer's Rule 13a-14(a)/15d-14(a) Certification *
31.2	Chief Financial Officer's Rule 13a-14(a)/15d-14(a) Certification *
32.1	Chief Executive Officer's Section 1350 Certification
32.2	Chief Financial Officer's Section 1350 Certification

* Filed herewith.

Furnished herewith.